S. HRG. 98-85, Pt. 1

NATURAL GAS LEGISLATION

HEARINGS

BEFORE THE

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 615, S. 60, S. 239, S. 291, S. 293, S. 370, S. 689

MARCH 9, 10, 11, 12, AND 22, 1983

PART 1

Printed for the use of the
Committee on Energy and Natural Resources

22-353 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1983

S311-40

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NATURAL GAS LEGISLATION

WEDNESDAY, MARCH 9, 1983

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-366, Dirksen Office Building, Hon. James A. McClure (chairman) presiding.

Present: Senators McClure, Weicker, Wallop, Warner, Murkowski, Nickles, Hecht, Heinz, Johnston, Jackson, Bumpers, Ford, Metzenbaum, Melcher, and Bradley.

Also present: Charles A. Trabandt, chief counsel; E. David Doane, deputy chief counsel for energy; Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. JAMES A. McCLURE, A U.S. SENATOR FROM THE STATE OF IDAHO

The CHAIRMAN. The committee will come to order.

The hearing today is the first of 4 consecutive days of hearings on natural gas legislation introduced in the Senate during the first 2 months of this Congress. Seven bills are now pending before this committee. One of those proposals is the Reagan administration's bill, S. 615, which I introduced at the administration's request.

S. 615 is a comprehensive proposal with many interlocking features. It deserves, and will receive, thorough consideration by this committee, and it will therefore be the primary focus of these hearings. However, the committee welcomes testimony on the other pending proposals, which include S. 689, introduced last week by Senator Heinz.

At the outset of these hearings, we should consider whether we have the option of taking no action on natural gas, of not even attempting to legislate on this complex and divisive issue. It has been suggested that a stalemate is inevitable, because those opposing any particular proposal would have the votes to block it.

In fact, the threat of a filibuster was made within 60 seconds of the President's radio announcement of his decision to send a bill.

Senator FORD. I think it was 32.

The CHAIRMAN. It has also become quite clear that within the gas industry there is not yet a clear consensus on how to resolve the basic natural gas issues.

In my judgment, we have no choice but to overcome those problems and press forward in this committee to consider comprehensive natural gas legislation this year. The best schedule, of course, would be to act in this committee in a timeframe which would allow Congress ultimately to send a bill to the President this fall, before the new heating season begins.

If the Congress fails to act, gas prices probably will continue to increase under existing law at a rate that is simply unacceptable. Natural gas consumers throughout the country are complaining bitterly about prices. They are demanding an end to the sharp escalations in prices that have occurred in the past 2 years.

Under the Natural Gas Policy Act of 1978, further increases would be inevitable, regardless of what occurs in the gas markets. The NGPA permits automatic monthly increases in the prices of large volumes of new gas—gas produced from wells drilled after February 1977.

This statutory price increase mechanism shows no mercy. It is blind to changes in market conditions. Despite a decline in demand and a surplus of deliverable supply, this pricing mechanism relentlessly continues to push up prices without regard for consumers ability to pay. In fact, many observers believe that natural gas prices in some markets already have reached or exceeded market clearing levels, and that result may be fast approaching on a nationwide basis in light of decreasing world oil prices.

Another reason for the continuing increase in gas prices is the fact that our supply of old gas, which is relatively inexpensive and comes from wells drilled before 1977, is being gradually depleted and replaced with new gas, which is considerably more expensive.

Another serious pricing problem is the high price of gas imports. The current price of gas imported from Canada is $4.94 per thousand cubic feet, a price that is excessive by every measure. The price of liquified natural gas is also much too high. We must determine whether the prices of imported gas can be reduced through market responses and resulting voluntary renegotiation of existing contracts.

If we find that imported gas prices will remain insulated from the market prices that are being applied to domestic gas, then further action by the Congress may be the only remedy. I would hope at this point that we are not forced to legislate on imports, but rather that we can depend on market pressures and voluntary action by foreign suppliers.

As we consider the various proposals for reducing retail gas prices, we must keep in mind that our fundamental task—and a true challenge—is to fashion legislation that will work. Two relatively recent developments in the natural gas market have an important bearing on our judgment of what will work.

The first development is the decline in demand for natural gas in the retail markets, a decline caused by conservation, fuel switching, the recession, and warmer-than-normal weather. Because of reduced demand a number of major pipelines have virtually stopped signing contracts with producers for the purchase of additional volumes of gas. They simply cannot sell additional amounts of gas at current prices. Many pipelines have exercised market-out clauses or significantly reduced their so-called takes under existing contract.

This situation certainly did not exist in 1978, when the Congress last considered the issue of natural gas pricing. In fact, during the 29 years that producers have been subjected to wellhead price controls, they were always able to sell the gas they produced. The factor controlling how much they produced was the price. Today, the controlling factor is lack of demand. Consequently, many producers do not have buyers for gas from newly completed wells, and production is declining.

I mention this point because of its obvious relevance to the administration bill, which is based on the premise that if a free market were permitted to work today, it would act as an effective restraint on wellhead prices. The question then becomes, with limits on demand in the retail gas markets, how effectively will demand restrain price? I am looking forward to the testimony on that issue.

The second recent development is the sharp reduction in oil and gas drilling operations in this country. The downturn in drilling activity started during the second half of last year, and it appears to be continuing. During the last week of February of this year, the number of operating drilling rigs declined by 76 units to a total of 2,147, which is a 47-percent reduction from the number of rigs operating just 1 year ago.

This drop in drilling activity may suggest that we will have to contend with a new gas shortage 2 or 3 years from now if production incentives are not increased in the meantime. I expect that we will receive considerable comment on this issue during the next 4 days.

We must not lose sight of the fact that the fundamental objective of any natural gas bill must be to achieve a balance between the need to limit consumer gas prices and the equally important need to insure that gas shortages do not occur later in this decade. We must achieve that balance. Above all, we must avoid enacting legislation that does nothing more that compel gas consumers, in the long run, simply to exchange one form of economic hardship for another.

Our hearings over the next 4 days will provide the opportunity to consider these critical issues, as we review the President's bill and the other pending legislation.

[The texts of S. 615, S. 60, S. 239, S. 291, S. 293, S. 370, and S. 689 follow:]

II

98TH CONGRESS
1ST SESSION

S. 615

To cover deficiencies in the Natural Gas Policy Act of 1978, to protect natural gas consumers from price increases because of current distortions in the regulated market for natural gas, to provide for a free market for natural gas, to permit natural gas contracts to reflect the change from a regulated to a free market, to eliminate incremental pricing requirements for natural gas, to eliminate certain fuel use restrictions, and for other purposes.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 28 (legislative day, FEBRUARY 23), 1983

Mr. McCLURE introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To cover deficiencies in the Natural Gas Policy Act of 1978, to protect natural gas consumers from price increases because of current distortions in the regulated market for natural gas, to provide for a free market for natural gas, to permit natural gas contracts to reflect the change from a regulated to a free market, to eliminate incremental pricing requirements for natural gas, to eliminate certain fuel use restrictions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Natural Gas Consumer Regulatory Reform Amendments of 1983".

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Sec. 202. Repeal of Natural Gas Act jurisdiction over first sales of committed or dedicated natural gas.
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TITLE I—PURCHASED GAS COST

PURCHASED GAS COST

SEC. 101. (a) Title VI of the Natural Gas Policy Act of 1978 (15 U.S.C. 3431 et seq.) is amended by adding a new section 603 to read as follows:

"SEC. 603. LIMITATION ON THE PASSTHROUGH OF CERTAIN PURCHASED GAS COSTS.

"(a) LIMITATION ON PURCHASED GAS ADJUSTMENTS.—Notwithstanding section 601(c) of this Act, for purposes of sections 4 and 5 of the Natural Gas Act, from the first day of the first month following enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 through December 31, 1985, the part of a pipeline's rate that reflects purchased gas costs may not exceed its allowed rate for purchased gas cost, except as provided in subsection (b).

"(b) RECOVERY OF ADDITIONAL PURCHASED GAS COST.—A pipeline may file an application under this subsection with the Commission to increase its rates to reflect any purchased gas cost that subsection (a) of this section prevents it from recovering. Notwithstanding section 4(e) of the Natural Gas Act, no increase to the rates of a pipeline that may be recovered under this subsection may go into effect unless the Commission, after opportunity for hearing, issues an order that grants the application, in whole or in part, with such modifications and upon such terms and conditions as the Commission may find necessary and appropriate. The proceeding under this subsection shall be conducted by the Commission separately from proceedings on other rate applications that are filed under section 4 of the Natural Gas Act. In any such proceeding, the Commission shall allow recovery if it determines that the costs sought to be recovered were just, reasonable, and prudently incurred. In making this determination, the Commission shall consider the reasonable availability of lower cost supplies to the pipeline and the necessity of such costs for the pipeline to render adequate service to its existing customers. Within sixty days of the date of the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, the Commission shall prescribe rules for applications under this subsection. These rules shall facilitate expeditious decisions on these applications.

"(c) DEFINITIONS.—

"(1) ALLOWED RATE FOR PURCHASED GAS.—The term 'allowed rate for purchased gas' means, for a particular pipeline, for a particular month, the pipeline's average cost per million Btu's for purchased gas delivered to the pipeline during the month preceding the enactment of the Natural Gas Consumer Regulatory Reform Act of 1983 plus the adjustment amount for that particular month.

"(2) ADJUSTMENT AMOUNT.—The term 'adjustment amount' means, for a particular month, the difference between the national rate and the adjusted national rate for that particular month.

"(3) NATIONAL RATE.—The term 'national rate' means the national average cost per million Btu's for purchased gas delivered to all interstate pipelines during the month preceding the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983.

"(4) ADJUSTED NATIONAL RATE.—The term 'adjusted national rate' means—

"(A) for the month in which the Natural Gas Consumer Regulatory Reform Amendments of 1983 is enacted, the national rate multiplied by the annual inflation adjustment factor (as defined in section 101(a) of this Act) for that month; and

"(B) for any particular succeeding month, the adjusted national rate for the preceding month multiplied by the annual inflation factor (as defined in section 101(a) of this Act) for that particular month.

"(d) REPORTING REQUIREMENT.—By the fifth day following the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, each interstate pipeline shall report its average cost per million Btu's for purchased gas delivered to it during the month preceding the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 and the volume of purchased gas delivered to it during that month.

"(e) PUBLICATION.—The Commission shall compute and publish the adjustment amount for each month at least five days before the beginning of that month.

"(f) AFFILIATED PRODUCTION.—No interstate pipeline may recover any costs associated with its own production or purchases from any affiliated producer to the extent such production or purchases were not reduced to a percentage of deliverability no higher than the percentage of deliverability to which the pipeline had exercised contemporaneously a contractual right to reduce its takes of less expensive gas.".

(b) The table of contents of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301 note) is amended by inserting after the item relating to section 602 the following:

"Sec. 603. Purchased Gas Cost."

TITLE II—REMOVAL OF WELLHEAD PRICE CONTROLS AND REPEAL OF JURISDICTION OVER CERTAIN FIRST SALES

REMOVAL OF WELLHEAD PRICE CONTROLS

SEC. 201. Section 121 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3331) is amended to read as follows:

"SEC. 121. ELIMINATION OF PRICE CONTROLS FOR CERTAIN NATURAL GAS SALES.

"(a) GENERAL RULE.—The provisions of subtitle A respecting the maximum lawful price for any first sale of natural gas shall cease to apply to any first sale of natural gas subject to any contract that was executed or amended after the date of enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, unless the contract specifically provides that the contract shall not operate to terminate the application of subtitle A.

"(b) HIGH-COST NATURAL GAS.—Except as provided in subsection (a) of this section, with respect to the first sale of high-cost natural gas which is described in section 107(c) (1), (2), (3), or (4)—

"(1) beginning on the effective date of the incremental pricing rule required under section 201, the provisions of subtitle A respecting the maximum lawful price for the first sale of natural gas shall cease to apply; and

"(2) beginning on the date of enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 through December 31, 1985, the price shall not exceed the higher of the contract price on the date of the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 or the gas cap price, if published, for the month during which the gas is delivered.

"(c) SPECIAL RULE FOR CERTAIN GAS.—Except as provided in subsection (a), with respect to the first sale of gas covered by this subsection—

"(1) beginning January 1, 1985, the provision of subtitle A respecting the maximum lawful price shall cease to apply; and

"(2) beginning January 1, 1985, through December 31, 1985, the price shall not exceed the gas cap price for the month during which the gas is delivered.

"(3) GAS COVERED BY THIS SUBSECTION.—This subsection applies to—

"(A) new natural gas (as defined in section 102(c));

"(B) natural gas produced from any new, onshore production well (as defined in section 103(c)), if such natural gas—

"(i) was not committed or dedicated to interstate commerce on April 20, 1977; and

"(ii) is produced from a completion location which is located at a depth of more than 5,000 feet; and

"(C) natural gas sold under an existing contract, any successor to an existing contract, or any rollover contract, if—

"(i) such natural gas was not committed or dedicated to interstate commerce on the day before the date of the enactment of this Act; and

"(ii) the price paid for the last deliveries of such natural gas occurring on December 31, 1984, or, if no deliveries occurred on such date, the price that would have been paid had deliveries occurred on such date is higher than $1 per million Btu's.

"(d) Removal of Wellhead Price Controls on All Natural Gas.—Except as provided in subsections (a), (b), or (c), beginning January 1, 1986, the provisions of subtitle A respecting maximum lawful price shall cease to apply to the first sale of any natural gas.".

REPEAL OF NATURAL GAS ACT JURISDICTION OVER FIRST SALES OF COMMITTED OR DEDICATED NATURAL GAS

Sec. 202. Section 601(a)(1)(B) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3431(a)(1)(B)) is amended to read as follows:

"(B) Committed or dedicated natural gas.—Effective on January 1, 1985, for the purposes of section 1(b) of the Natural Gas Act, the provisions of such Act and the jurisdiction of the Commission shall not apply solely by reason of any first sale of natural gas which was committed or dedicated to interstate commerce as of the day before the date of enactment of this subsection. Effective on the date of enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 through December 31, 1984, for the purposes of section 1(b) of the Natural Gas Act, the provisions of such Act and the jurisdiction of the Commission under such Act shall not apply solely by reason of any first sale of natural gas which is committed or dedicated to interstate commerce as of the day before the date of enactment of this Act and which is—

"(i) high-cost natural gas (as defined in section 107(c) (1), (2), (3), or (4) of this Act);

"(ii) new natural gas (as defined in section 102(c) of this Act);

"(iii) natural gas produced from any new, onshore production well (as defined in section 103(c) of this Act);

"(iv) natural gas exempted from the operation of subtitle A of title I pursuant to section 121(a); or

"(v) natural gas that was subject to a contract that expired, lapsed, was terminated pursuant to its own terms, or was terminated pursuant to the provisions of section 316 of this Act.".

REPEAL OF PROVISIONS ALLOWING REIMPOSITION OF PRICE CONTROLS AND REPORT TO CONGRESS

SEC. 203. (a) Sections 122, 123, and 507 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3332, 3333, and 3417) are repealed.

(b) The table of contents of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301 note) is amended by striking the items relating to sections 122, 123, and 507.

TITLE III—TRANSITIONAL PRICE AND CONTRACT PROVISIONS

LIMITATION ON CEILING PRICES FOR CERTAIN NATURAL GAS

SEC. 301. (a) Title I of the Natural Gas Policy Act of 1978 (15 U.S.C. 3311–3333) is amended by adding the following new section:

"SEC 111. LIMITATION ON CEILING PRICES FOR CERTAIN NATURAL GAS.

"(a) GENERAL RULE.—Except as provided in section 121 of this Act, beginning on the date of enactment of this section, the maximum lawful price of any first sale of natural gas subject to this subtitle shall not exceed the lower of the applicable price as calculated pursuant to sections 102 through 106, 108, and 109 or the gas cap price, if published, for the month during which the gas is delivered.

"(b) SPECIAL RULE FOR SECTION 107(c)(5) GAS.—Except as provided in section 121 of this Act, beginning on the date of the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, the maximum lawful price for gas described in subsection (c)(5) of section 107 of this Act shall be no higher than the maximum lawful price for such gas during the month in which the Natural Gas Consumer Regulatory Reform Amendments of 1983 are enacted.

"(c) DEFINITION OF GAS CAP PRICE.—The term 'gas cap price' means, for a particular month, the volume-weighted average price of natural gas that is estimated to be—

"(1) delivered during the second, third, and fourth months preceding that particular month; and

"(2) delivered during the first three months of deliveries under a contract filed under subsection (e) of this section.

"(d) CALCULATION AND PUBLICATION OF THE GAS CAP PRICE.—Beginning with the fourth month after enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, the Commission (in accordance with section 101(a)(6) of this subtitle) shall compute and publish the gas cap price for each month through December 1985.

"(e) FILING REQUIREMENT.—A purchaser of natural gas subject to a first sale contract executed or amended on or after the date of the enactment of the Natural Gas Consumer

Regulatory Reform Amendments of 1983 shall file with the Commission within five days of the date on which the contract is executed or amended—

"(1) a summary of the contract and all ancillary agreements, including all pricing provisions;

"(2) the prices to be paid under the contract during the first three months of deliveries;

"(3) the estimated volumes (in millions of Btu's) to be delivered during the first year of the contract; and

"(4) any additional data required by the Commission.

This filing requirement does not apply in the case of an amendment of a contract for which data previously relating to price has been filed with the Commission under this subsection.

"(f) COMMISSION RULES.—Within thirty days of the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, the Commission shall issue rules to implement this section.".

(b) The table of contents of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301 note) is amended by inserting after the item relating to section 110 the following:

"Sec. 111. Limitation on Ceiling Prices for Certain Natural Gas.".

(c) Section 101(b)(5) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3311(b)(5)) is amended by striking the period at the end and inserting the following: ", but in no event shall the operation of this paragraph be deemed to entitle any seller to collect a price in excess of that established pursuant to section 111.".

(d) Section 105(b)(3)(B) of the Natural Gas Policy Act of 1978 is amended by adding a new sentence at the end to read as follows: "This definition shall not include any clause which establishes the price for natural gas exempted from the operation of this subtitle pursuant to section 121(a).".

REPEAL OF CERTAIN CONTRACT REQUIREMENTS AND IMPOSITION OF TAKE-OR-PAY LIMITS

SEC. 302. (a) Section 315 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3375) is repealed, and a new section 315 is inserted in its place to read as follows:

"SEC. 315. IMPOSITION OF TAKE-OR-PAY LIMITS.

"(a) GENERAL RULE.—In the case of any first sale contract in effect on the date of enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, which has not been amended subsequent to the date of enactment, and which contains a clause requiring a purchaser to take delivery of, or if not taken, to pay for, volumes of gas in excess of 70 per centum of available deliverability from those wells included under a contract, the purchaser may exercise without obligation to pay for volumes not taken in excess of 70 per centum of well deliverability, a right not to accept delivery of any portion of the total volume which exceeds 70 per centum of well deliverability. This right applies only to deliveries under a contract from the date of enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 through December 31, 1985.

"(b) NOTICE REQUIREMENT.—Any purchaser electing to reduce volumes purchased pursuant to this section must give the seller a minimum of thirty days written notice prior to the date of delivery of the natural gas involved.

"(c) RELEASE OF CONTRACTUAL OBLIGATIONS.—Upon receipt of the notice provided for in subsection (b), the seller shall have the right to terminate the contract with respect only to amounts not taken by reason of this section. If the seller elects to terminate the contract in accordance with this section, the purchaser shall tender to the seller full and unconditional release from all duties and obligations in contract or in law. The purchaser, if a transporter of natural gas, shall tender transportation in accordance with the provisions of section 316(d) of this Act.

"(d) DRAINAGE SITUATIONS.—The Commission, by rule or order, may determine that this section shall not apply to the extent the production of the volume for which delivery is required to be taken is necessary in order to prevent drainage and protect the correlative rights of the person producing the natural gas involved.

"(e) CASINGHEAD NATURAL GAS.—This section shall not apply to casinghead natural gas.

"(f) CONTRACTS COVERING MORE THAN ONE CATEGORY OF NATURAL GAS.—For purposes of this section, any contract establishing two or more categories of natural gas for purposes of pricing the natural gas delivered under the contract shall be treated as separate contracts for each such category.".

(b) The table of contents of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301 note) is amended by striking the item relating to section 315 and inserting in its place the following:

"Sec. 315. Imposition of Take-or-Pay Limits.".

MARKET-OUT PROVISION

SEC. 303. (a) Title III of the Natural Gas Policy Act of 1978 (15 U.S.C. 3361–3375) is amended by adding a new section 316 to read as follows:

"SEC. 316. MARKET-OUT PROVISION.

"(a) GENERAL RULE.—Beginning January 1, 1985, either party to a contract for the first sale of natural gas which was in effect on the date of enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983 and which contract was not thereafter amended shall have the right to terminate the contract under the following conditions:

"(1) the party wishing to terminate the contract must give notice to the other party between November 16, 1984, and November 15, 1985, and at least forty-five days in advance, that the contract is to be terminated;

"(2) the party giving notice of termination does not materially breach the contract at any time prior to the end of the notice period; and

"(3) the party giving notice of termination must offer to the other party a full and unconditional release from all future duties and obligations in contract or in law relating to the contract, which release is effective upon termination of the notice period.

"(b) EFFECT OF SECTION 315 REDUCTION.—A reduction of a take-or-pay obligation pursuant to section 315 of this Act shall not be considered an amendment for purposes of subsection (a) of this section.

"(c) OBLIGATIONS OF PARTIES UPON TERMINATION.—Neither party to a contract terminated pursuant to this section shall have an obligation to perform any act because of the contract on and after the effective date of the termination of the contract, except that a party that has received a good or service under the contract before the effective date of its termination shall have a duty to pay for that good or service as provided for in the contract and that a party that has received payment under the contract for a good or service that was not provided before the effective date of its termination shall have a duty to make restitution of the payment in cash or in kind in accordance with the contract.

"(d) TRANSPORTATION OBLIGATION.—

"(1) IN GENERAL.—In the event that a contract is terminated under this section, a pipeline that was a party to the terminated contract shall have an obligation to transport natural gas for a producer that was a party to the terminated contract. The obligation of the pipeline shall not exceed on an annual basis the largest volume delivered under the contract during any twelve consecutive months in the thirty-six months prior to its termination.

"(2) LIMITATION OF OBLIGATION.—The Commission, or in the case of an intrastate pipeline the State agency with jurisdiction over that pipeline, upon application by the pipeline and after opportunity for hearing, may order a limitation of the obligation of the pipeline under this subsection if compliance with the obligation would require construction of additional facilities or would impair the ability of the pipeline to render adequate service to its existing customers.

"(3) CONSIDERATION.—The consideration for any transportation provided under this subsection shall be $0.05 per million Btu's plus the cost of such transportation, as established by the appropriate State or Federal regulatory body, unless the Commission has established, by rule, a different rate as just compensation for such transportation. No amount of such consideration shall be required to be credited and flowed back to the customers of such pipeline.".

(b) The table of contents of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301 note) is amended by inserting after the item relating to section 315 the following:

"Sec. 316. Market-Out Provision.".

EFFECT OF GAS CAP PRICE

SEC. 304. (a) Title III of the Natural Gas Policy Act of 1978 (15 U.S.C. 3361–3375) is amended by adding a new section 318 to read as follows:

"SEC. 318. EFFECT OF GAS CAP PRICE.

"(a) Price Escalator Clauses.—Except for natural gas described in section 107 of this Act, no price escalator clause may operate to establish a price for natural gas which is subject to the provisions of subtitle A respecting the maximum lawful price for the first sale of natural gas higher than the gas cap price. For purposes of this subsection, the term "price escalator clause" means any contract clause that provides for a periodic price increase, either on a fixed or indefinite basis, or that references other natural gas prices, federally imposed price ceilings, or prices of other commodities.

"(b) AREA RATE CLAUSES.—For purposes of an area rate clause, the gas cap is a Federally established rate or price. After December 31, 1985, the gas cap price for December 1985 is a federally established rate or price.".

(b) The table of contents of the Natural Gas Policy Act of 1978 (U.S.C. 3301 note) is amended by inserting after the item relating to section 317 the following:

"Sec. 318. Effect of Gas Cap Price.".

TITLE IV—REMOVAL OF IMPEDIMENTS TO INTERSTATE MOVEMENTS OF GAS

AUTHORIZATION OF CERTAIN INTERSTATE SALES, TRANSPORTATION AND ASSIGNMENTS

SEC. 401. (a) Section 311(a) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3371(a)) is amended by—

(1) amending subparagraph (A) of paragraph (1) to read as follows:

"(A) IN GENERAL.—The Commission may, by rule or order, authorize any interstate pipeline to transport natural gas on behalf of any person.".

(2) inserting "AND LOCAL DISTRIBUTION COMPANIES" after "INTRASTATE PIPELINES" in the paragraph (2) heading;

(3) inserting in paragraph (2) "or local distribution company" after "intrastate pipeline";

(4) amending subparagraph (A) of paragraph (2) to read as follows:

"(A) IN GENERAL.—The Commission may, by rule or order, authorize any intrastate pipeline or local distribution company to transport natural gas on behalf of any person.".

(5) in subparagraph (B)(ii) (I) and (II) of paragraph (2), inserting "or company" after "pipeline".

(b) Section 311(b) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3371(b)) is amended by—

(1) amending paragraph (1) to read as follows:

"(1) IN GENERAL.—The Commission may, by rule or order, authorize any pipeline or local distribution company to sell natural gas to any pipeline or local distribution company.".

(2) amending paragraph (2) by—

(A) striking "MAXIMUM FAIR AND EQUITABLE PRICE" after the subparagraph designator "A" and inserting in its place "INTRASTATE PIPELINES AND LOCAL DISTRIBUTION COMPANIES";

(B) inserting "or local distribution company" following "pipeline" and "or local distribution company's" following "pipeline's" wherever they appear; and

(C) inserting "(including storage)" after "transportation" in clause (i) of subparagraph (B);

(D) adding a new subparagraph (D) to read as follows:

"(D) INTERSTATE PIPELINES.—The rates and charges of any interstate pipeline with respect to any sales authorized under subsection (b)(1)(A) shall be just and reasonable (within the meaning of the Natural Gas Act).";

(3) in paragraph (4), striking "pipeline's" and inserting in its place "seller's", and striking "INTRASTATE" in the heading and inserting in its place "EXISTING";

(4) in paragraphs (4)–(7), except for subparagraph (5)(a)(i), striking "intrastate pipeline" or "pipeline" wherever they appear and inserting in their place "seller";

(5) in paragraph (5)(A)(i), striking "interstate pipeline or local distribution" and inserting in its place "purchasing"; and

(6) adding a new paragraph (8) to read as follows:

"(8) DEFINITION OF SELLER.—For purposes of this subsection, the term 'seller' means any person that sells gas under paragraph (b)(1).".

(c) Section 312 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3372) is amended—

(1) by amending subsection (a) to read as follows:

"(a) AUTHORIZATION OF ASSIGNMENTS.—The Commission may, by rule or order, authorize a pipeline or local distribution company to assign, without compensation, to any other pipeline or local distribution company, all or any portion of the assignor's right to receive surplus natural gas at any first sale, upon such terms and conditions as the Commission determines appropriate."; and

(2) by amending subsection (c) to read as follows:

"(c) SURPLUS NATURAL GAS.—For purposes of this section, the term 'surplus natural gas' means, with respect to any pipeline or local distribution company, any natural gas which exceeds the then current demands of such person for natural gas, as determined by—

"(1) the Commission, or

"(2) the State agency having regulatory jurisdiction over that person.".

ACCESS TO INTERSTATE SUPPLY SOURCES

SEC. 402. (a) Section 314 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3374) is amended by—

(1) striking "first" in subsection (a), and

(2) amending subsection (b) to read as follows:

"(b) NATURAL GAS COVERED BY THIS ACT.—For purposes of subsection (a), the term 'natural gas covered by this Act' means—

"(1) for any first sale contract, natural gas—

"(A) which is not subject to the jurisdiction of the Commission under the Natural Gas Act by reason of section 601(a)(1) (A) or (B);

"(B) the sale in interstate commerce of which—

"(i) is authorized under section 302(a) or 311(b); or

"(ii) is pursuant to an assignment under section 312(a); or

"(C) the transportation in interstate commerce of which is—

"(i) pursuant to any order under section 302(c) or section 303 (b), (c), (d), or (h), or

"(ii) authorized by the Commission under section 311(a); or

"(2) for any contract, natural gas the sale or transportation of which under the contract is not in interstate commerce by reason of section 601(d) of this Act.".

(b) Section 601 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3431) is amended by adding new subsections (d) and (e) to read as follows:

"(d) LIMITATION OF COMMISSION JURISDICTION OVER INTRASTATE TRANSACTIONS.—

"(1) GENERAL RULE.—No intrastate pipeline or local distribution company shall be subject to the jurisdiction of the Commission under the Natural Gas Act by reason of purchasing natural gas in a covered transaction.

"(2) SUBSEQUENT TRANSACTIONS.—Any transportation or sale of natural gas purchased in a covered transaction which occurs beyond the point at which such gas is received in the facilities of the purchaser in the covered transaction shall not be in interstate commerce (within the meaning of the Natural Gas Act) and shall not be subject to the jurisdiction of the Commission under the Natural Gas Act to the extent that such gas remains in the State of purchase.

"(3) NATURAL-GAS COMPANY.—For purposes of the Natural Gas Act, the term 'natural-gas company' (as defined in section 2(6) of that Act) shall not include any person by reason of, or with respect to, any transportation or sale of natural gas if the transportation or sale is not subject to the jurisdiction of the Commission solely by reason of paragraph (2) of this subsection.

"(4) STATE OF PURCHASE RULE.—For purposes of this subsection, natural gas shall be deemed to remain in the State of purchase if the gas is not transported outside the State in which it was received into the facilities of the purchaser of the gas in a covered transaction, unless such transportation occurs in connection with—

"(A) transportation authorized under sections 302(a) or 311(a) of this Act, or

"(B) a sale or assignment authorized under sections 311(b) or 312 of this Act.

"(5) DEFINITION OF COVERED TRANSACTION.—For purposes of this subsection, the term 'covered transaction' means—

"(A) a first sale of gas—

"(i) which is not subject to the jurisdiction of the Commission under the Natural Gas Act by reason of subparagraph (A) or (B) of paragraph (1) of subsection (a),

"(ii) which is produced on the Outer Continental Shelf, or "(iii) which is transported pursuant to an order issued under section 317 of this Act;

"(B) a sale or assignment authorized under section 302(a), 311(b), or 312(a) of this Act; or

"(C) a sale for resale by any person not subject to the jurisdiction of the Commission solely by reason of section 1(c) of the Natural Gas Act.

"(e) NONDISCRIMINATION PROVISION.—The Commission may not condition or deny any authorization of the sale or transportation of natural gas under this Act or the Natural Gas Act on the basis of whether the gas is consumed in the interstate market or the intrastate market.".

CONTRACT CARRIER AUTHORIZATION

SEC. 403. (a) Title III of the Natural Gas Policy Act of 1978 (15 U.S.C. 3361–3375) is amended by adding a new section 317 to read as follows:

"SEC. 317. CONTRACT CARRIER AUTHORIZATION.

"(a) IN GENERAL.—Upon application by a producer of natural gas or by a purchaser of natural gas from a producer, the Commission shall order any interstate pipeline to carry gas under contract between producer and purchaser upon such terms and subject to such conditions as it considers just and reasonable if the Commission finds that such pipeline has available capacity, that no undue will be place upon such pipeline, that no construction of new facilities would be required, and that such order would not impair the ability of such pipeline to render adequate service to its existing customers. The Commission may implement this section by rule or order.

"(b) CONSIDERATION.—The consideration for any transportation provided under this section shall be $.05 per million Btu's plus the cost of such transportation, as established by the Commission, unless the Commission has established, by rule, a different rate as just compensation for such transportation. No amount of such consideration shall be required to be credited and flowed back to the customers of such pipeline.".

(b) The table of contents of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301 note) is amended by inserting after the item relating to section 316 the following:

"Sec. 317. Contract Carrier Authorization.".

TITLE V—REPEAL OF CERTAIN RESTRICTIONS ON NATURAL GAS AND PETROLEUM USE AND PRICING

REPEAL OF CERTAIN SECTIONS OF THE POWERPLANT AND INDUSTRIAL FUEL USE ACT OF 1978

SEC. 501. (a) The following sections of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8301 et seq.) are repealed:

(1) section 102 (a)(16), (a)(18), (a)(19), and (a)(29)) (42 U.S.C. 8302 (a)(16), (a)(18), (a)(19), and (a)(29));

(2) sections 201 and 202 (42 U.S.C. 8311 and 8312);

(3) section 302 (42 U.S.C. 8342);

(4) section 401 (42 U.S.C. 8371);

(5) section 402 (42 U.S.C. 8372); and

(6) section 405 (42 U.S.C. 8375).

(b) The table of contents in section 101(b) of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8301(b)) is amended by striking the items relating to the sections repealed by subsection (a) of this section.

CONFORMING AMENDMENTS

SEC. 502. (a) Section 102 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8301) is amended by striking "and major fuel-burning installations" and "and new" wherever these phrases appear.

(b) Section 103 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8302) is amended—

(1) in subsection (a)(13)(B), by—

(A) striking clause (ii)(III);

(B) striking "; or" at the end of clause (ii)(II), and inserting a period in its place; and

(C) inserting "and" at the end of clause (ii)(I);

(2) in subsection (a)(15), by striking "or major fuel-burning installation" and "or new" wherever these phrases appear;

(3) in subsection (a)(20), by striking "or major fuel-burning installation";

(4) by redesignating subsections (a)(17), (a)(20), (a)(21), (a)(22), (a)(23), (a)(24), (a)(25), (a)(26), (a)(27), and (a)(28) as subsections (a)(16), (a)(17), (a)(18), (a)(19), (a)(20), (a)(21), (a)(22), (a)(23), (a)(24), and (a)(25);

(5) in subsection (b), by striking "or major fuel-burning installation" wherever this phrase appears;

(6) in subsection (b)(1)(D), by striking everything after "synthetic gas involved" and inserting in its place a period; and

(7) by striking subsection (b)(3), and redesignating subsection (b)(4) as subsection (b)(3).

(c) Section 104 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8303) is amended to read as follows:

"The provisions of this Act shall apply in all the States, Puerto Rico, and the territories and possessions of the United States.".

(d) Section 303 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8343) is amended—

(1) by striking "or installation" and "or installations" wherever the phrases appear;

(2) by striking "or 302" wherever the phrase appears;

(3) by striking subsection (a)(3);

(4) by amending subsection (b)(1) to read as follows:

"(1) The Secretary may prohibit, by rule, the use of natural gas or petroleum under section 301(b) in existing electric powerplants.";

(5) in subsection (b)(3), by striking "or major fuel-burning installation"; and

(6) by amending the last sentence of subsection (b)(3) to read as follows: "Any such rules shall not apply in the case of any existing electric powerplant with respect to which a comparable prohibition was issued by order.".

(e) Section 403 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8373) is amended by striking—

(1) in subsection (a)(1), "major fuel-burning installation, or other unit" and the comma immediately preceding this phrase and "installation, or unit" and the comma immediately preceding this phrase;

(2) in subsection (a)(2), "installation, or other unit" and the comma immediately preceding that

phrase, and "installation, or unit" and the comma immediately preceding that phrase;

(3) in subsection (a)(2), the last sentence; and

(4) subsection (a)(3).

(f) Section 404 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8374) is amended by striking—

(1) in subsection (c), "new or" in the phrase "applicable to any new or existing electric powerplant"; and

(2) subsection (g).

(g) Section 701 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8411) is amended by striking—

(1) in the last sentence of subsection (b), "or installation";

(2) subsection (c);

(3) in the title of subsection (d), "AND EXEMPTIONS";

(4) in the first sentence of subsection (d)(1), "or any petition for any order granting an exemption (or permit)";

(5) in subsection (d)(1)(B), "or in the consideration of such petition";

(6) in subsection (f), "or a petition for an exemption (or permit) under this Act (other than under section 402 or 404),"; and

(7) subsection (g).

(h) Section 702 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8412) is amended by striking—

(1) in the title of subsection (a), "OR EXEMPTION";

(2) in subsection (a), "or granting an exemption (or permit)";

(3) subsection (b), and redesignating subsection (c) as subsection (b);

(4) in the first sentence of subsection (b)(1) (as redesignated), "or by the denial of a petition for an order granting an exemption (or permit) referred to in subsection (b),";

(5) in the first sentence of subsection (b)(1) (as redesignated), "such rule, order, or denial is published under subsection (a) or (b)" and inserting in its place "such rule, or order is published under subsection (a)";

(6) in the first sentence of subsection (b)(2) (as redesignated), "the rule, order, or denial" and inserting in its place "the rule or order";

(7) in the second sentence of subsection (b)(2) (as redesignated), "(or denial thereof)"; and

(8) in subsection (b)(3) (as redesignated), "any such rule, order, or denial" and inserting in its place "any such rule or order".

(i) Section 711 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8421) is amended by striking in the first sentence of subsection (a), "or major fuel-burning installation".

(j) Section 721 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8431) is amended by striking subsection (c) and redesignating subsection (d) as subsection (c).

(k) Section 723 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8433) is amended by striking subsection (b) and redesignating subsections (c) and (d) as subsections (b) and (c).

(l) Section 731 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8441) is amended by striking—

(1) "or major fuel-burning installation" wherever the phrase appears; and

(2) "title II or" in subsections (a)(1) and (g)(3).

(m) Section 745 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8455) is amended by striking in the first sentence of subsection (a), "from new and existing electric powerplants and major fuel-burning installations" and inserting in its place "from existing electric powerplants".

(n) Section 761 of the Powerplant and Industrial Fuel Use Act of 1978 (42 U.S.C. 8471) is amended by striking—

(1) in subsection (a), "any existing or new electric powerplant or major fuel-burning installation" and inserting in its place "any existing electric powerplant"; and

(2) in subsection (b)—

(A) "new or" in the phrase "In the case of any new or existing facility"; and

(B) "except to the extent provided under section 212(b) or section 312(b)" and the comma immediately preceding that phrase.

REPEAL OF INCREMENTAL PRICING REQUIREMENTS

SEC. 503. (a) Subject to subsections (b) and (c) of this section, title II of the Natural Gas Policy Act of 1978 (15 U.S.C. 3341–3348) is repealed, and the items relating to title II are stricken from the table of contents of that Act.

(b) A rule promulgated by the Commission under title II of the Natural Gas Policy Act of 1978 shall continue in effect only with respect to the flow-through of costs incurred before the enactment of the Natural Gas Consumer Regulatory Reform Amendments of 1983, including any surcharges based on such costs.

(c) The Commission may take appropriate action to implement this section.

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II

98TH CONGRESS
1ST SESSION

S. 60

To amend the Natural Gas Policy Act of 1978, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JANUARY 26 (legislative day, JANUARY 25), 1983

Mrs. KASSEBAUM introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To amend the Natural Gas Policy Act of 1978, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subtitle A of title I of the Natural Gas Policy Act of 1978 is amended by adding at the end thereof the following:

"SEC. 111. PRICE FREEZE ON NATURAL GAS.

"(a) PRICE FREEZE.—Notwithstanding any other provision of law, the maximum lawful price applicable to any category of first sale of any natural gas in effect on October 1, 1982, shall continue to be the maximum lawful price for that gas for the period starting October 1, 1982, through January 1, 1985. Any first sale of natural gas which has a price lower than the maximum lawful price in effect on October 1, 1982, may increase by the lesser of the rate provided in the contract for such sale or the annual inflation adjustment factor as determined in section 101(a)(1) but may not exceed the maximum lawful price in effect on October 1, 1982, during the freeze period.

"(b) PRICE FREEZE ON NATURAL GAS NOT COVERED BY WELLHEAD PRICE CONTROLS.—Notwithstanding any other provision of law, the maximum lawful price for the period commencing October 1, 1982, and ending January 1, 1985, for any first sale of any category of natural gas for which a ceiling price is not specified on October 1, 1982, under this title and from a well the surface drilling of which began by October 1, 1982, shall be the contract price specified for deliveries of such natural gas on October 1, 1982, or if there was no contract price specified for deliveries of such natural gas on such date, the maximum lawful price shall be the price paid for comparable natural gas.

"(c) EXPIRATION OF PRICE FREEZE.—Following the expiration of the price freeze imposed by this section, the maximum lawful price for any first sale of natural gas for which a ceiling price is specified on October 1, 1982, shall increase from the October 1, 1982, level at the rate specified by this Act for that category of natural gas.".

(b) The table of contents for subtitle A of title I of the Natural Gas Policy Act of 1978 is amended by adding at the end thereof the following:

"Sec. 111. Price freeze on natural gas.".

SEC. 2. (a) Section 121 of subtitle B of title I of the Natural Gas Policy Act of 1978 is amended—

(1) in the matter before clause (1) of subsection (a) by striking out "January 1, 1985" and inserting in lieu thereof "January 1, 1987"; and

(2) in subsection (c), by striking out "July 1, 1987" and inserting in lieu thereof "July 1, 1989".

(b) Section 122 of such Act is amended—

(1) by striking out subsection (b)(1) and inserting in lieu thereof the following:

"(1) may not take effect earlier than July 1, 1987, nor later than June 30, 1989; and"; and

(2) in subsection (c), by striking out "May 31, 1985" both places it appears and inserting in lieu thereof "May 31, 1987".

(c) Section 123(a) of such Act is amended by striking out "On or before January 1, 1984, and on or before January 1, 1985," and inserting in lieu thereof "On or before January 1, 1986, and on or before January 1, 1987,".

SEC. 3. (a) Subsection (c)(2) of section 601 of title VI of the Natural Gas Policy Act of 1978 is amended (1) by inserting "imprudence," immediately after "abuse," and (2) by adding at the end of subsection (c)(2) the following: "Whenever the Commission determines, upon its own motion or the petition of any party, that—

"(i)(I) Any amount paid with respect to any purchase of natural gas is excessive due to fraud, abuse, imprudence, or similar grounds under this paragraph, or

"(II) Any rate or charge collected by any natural gas company in connection with any transportation or sale of natural gas is unreasonable or unjust under section 4 or 5 of the Natural Gas Act; and

"(ii) such rate, charge, or amount paid is the result of any contract between a pipeline company and a producer which contains a provision which the Commission determines prevents the pipeline company from responding to the demands of customers or other market forces by requiring the purchaser to pay for a minimum daily contract quantity of gas whether or not such gas is taken,

the Commission shall have the authority to take such appropriate action as it may deem necessary including the rescission, annulment, or modification of such contract provisions.".

(b) The Federal Energy Regulatory Commission shall take such action as may be necessary, within the ninety-day period following the date of the enactment of this Act, to devise and put into effect an incentive rate of return applicable to proceedings under the Natural Gas Act to stimulate the purchase of the maximum amount of lower cost gas which is consistent with gas availability and the need for a steady supply.

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II

98TH CONGRESS
1ST SESSION

S. 239

To clarify the definition of abuse in the Natural Gas Policy Act of 1978.

IN THE SENATE OF THE UNITED STATES

JANUARY 26 (legislative day, JANUARY 25), 1983

Mr. JEPSEN (for himself and Mr. GRASSLEY) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To clarify the definition of abuse in the Natural Gas Policy Act of 1978.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 2 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301) is amended by adding at the end thereof the following:

"(38) ABUSE.—The term 'abuse' is not limited to misrepresentation but also includes imprudence on the part of the pipeline company and any pipeline company-producer contract which materially prevents the pipeline from responding to changes in customer demand or other market forces. A rebuttable presumption arises that a contract materially prevents a pipeline from responding to changes in customer demand or other market forces if the following contract clauses are found in a producer-pipeline contract:

"(A) Take-or-pay clause which commits the purchaser to pay for a minimum daily contract quantity of gas greater than 70 percent of daily contract quantity on an annual basis whether or not such gas is taken.

"(B) Indefinite price escalator or redetermination clause which is not tied to a recognized and approved economic indicator.

"(C) Most favored nation clause where the purchase price paid by any pipeline to a producer is set by the highest price in a particular production area.

Such a rebuttable presumption also arises if a contract does not include a market-out-clause which allows the buyer to escape the contract or to nominate a new lower price if the gas is not marketable at the contract price.".

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II

98TH CONGRESS
1ST SESSION

S. 291

To amend the Natural Gas Policy Act of 1978 to prohibit take-or-pay clauses, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JANUARY 31 (legislative day, JANUARY 25), 1983

Mr. DANFORTH (for himself, Mr. EAGLETON, and Mr. SARBANES) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To amend the Natural Gas Policy Act of 1978 to prohibit take-or-pay clauses, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subtitle A of title I of the Natural Gas Policy Act of 1978 is amended by adding at the end thereof the following:

"SEC. 112. SUSPENSION OF CERTAIN PRICE RELATED CONTRACTUAL PROVISIONS.

"(a) Notwithstanding any other provision of law and except as provided in subsection (b), beginning on the date of enactment of this section, any provision of any contract for the first sale of natural gas which—

"(1) has the effect of requiring the purchaser to make payment to the seller if gas volumes tendered by the seller under the contract are not taken by the purchaser; or

"(2) provides for an indefinite price escalator clause as defined in section 105(b)(3)(B) of this Act,

shall be suspended and of no force or effect.

(b) Upon application made by purchaser or seller, the Commission may, after notice and, when the Commission deems it appropriate, an evidentiary hearing, by order reinstate such contractual arrangements, or any modification thereof found by the Commission to be consistent with the public interest, to become effective if the Commission finds—

"(1) that such contractual arrangements were made before the date of enactment of this section; and

"(2) that permitting such contractual arrangements, or a modification approved by the Commission, to become effective is necessary either—

"(A) to prevent a default by seller under a loan agreement or debt instrument in effect on the date of enactment of this section; or

"(B) because of field drainage requirements or similar reasons.

Any reinstatement or modification under clause (2) shall be granted only to the extent necessary to satisfy the requirements of such clause.".

(b) The table of contents for subtitle A of title I of the Natural Gas Policy Act of 1978 is amended by adding at the end thereof the following:

"Sec. 112. Suspension of Certain Price Related Contractual Provisions.".

SEC. 2. Subsection (c)(2) of section 601 of title VI of the Natural Gas Policy Act of 1978 is amended by inserting "imprudence (including failure to exercise all due prudence in securing the least-cost mix of gas)," immediately after "abuse,".

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II

98TH CONGRESS
1ST SESSION

S. 293

To amend the Natural Gas Policy Act of 1978 to prohibit increases in the wellhead prices of natural gas, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JANUARY 31 (legislative day, JANUARY 25), 1983

Mr. EAGLETON (for himself, Mr. DANFORTH, and Mr. SARBANES) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To amend the Natural Gas Policy Act of 1978 to prohibit increases in the wellhead prices of natural gas, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subtitle A of title I of the Natural Gas Policy Act of 1978 is amended by adding at the end thereof the following:

"SEC. 111. PRICE FREEZE ON NATURAL GAS; REPORT BY COMPTROLLER GENERAL CONCERNING PROFITABILITY OF NATURAL GAS PRODUCTION.

"(a) MAXIMUM LAWFUL PRICES.—Notwithstanding any other provision of law, the maximum lawful price applicable to the first sale of natural gas from January 31, 1983, through December 31, 1984, shall be the maximum lawful price applicable to such sale on August 31, 1982, under this Act. In the case of any first sale of natural gas from a well the surface drilling of which began prior to January 31, 1983, and for which there was no applicable maximum lawful price on August 31, 1982, solely by reason of the elimination of price controls pursuant to subtitle B of title I of this Act, the maximum lawful price for such sale from January 31, 1983, through December 31, 1984, shall be the contract price specified for deliveries of such natural gas on August 31, 1982: *Provided, however,* That if there was no contract price specified for deliveries of such natural gas on such date, the maximum lawful price shall be the average of the prices paid on August 31, 1982, for deliveries of natural gas from the three nearest wells by surface location for which there similarly was no applicable maximum lawful price on August 31, 1982.

"(b) EXPIRATION OF PRICE FREEZE.—The maximum lawful price applicable to the first sale of natural gas on August 31, 1982, shall be increased for any month beginning on or after January 1, 1985 at the rate specified for such gas by this Act.".

(b)(1) Section 121(a) of the Natural Gas Policy Act of 1978 is amended by striking out "January 1, 1985" and inserting in lieu thereof "January 1, 1987".

(2) Section 121(c) of such Act is amended by striking out "July 1, 1987" and inserting in lieu thereof "July 1, 1989".

(c)(1) Section 122(b) of the Natural Gas Policy Act of 1978 is amended by striking out "July 1, 1985" and inserting in lieu thereof "July 1, 1987".

(2) Section 122(b) is further amended by striking out "June 30, 1987" and inserting in lieu thereof "June 30, 1989".

(3) Section 121(c) of such Act is amended by striking out "May 1, 1985" wherever it appears and inserting in lieu thereof "May 1, 1987".

(d)(1) Section 123 of the Natural Gas Policy Act of 1978 is amended by striking out "July 1, 1984" and inserting in lieu thereof "July 1, 1986".

(2) Section 123 is further amended by striking out "January 1, 1985" and inserting in lieu thereof "January 1, 1987".

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II

98TH CONGRESS
1ST SESSION

S. 370

Entitled the "Imported Liquefied Natural Gas Policy Act of 1983".

IN THE SENATE OF THE UNITED STATES

FEBRUARY 1 (legislative day, JANUARY 25), 1983

Mr. PERCY (for himself and Mr. DIXON) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

Entitled the "Imported Liquefied Natural Gas Policy Act of 1983".

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Imported Liquefied Natural Gas Policy Act of 1983".

SECTION 1. Subtitle A of title I of the Natural Gas Policy Act of 1978 is amended by adding at the end thereof the following:

"SEC. 111. RATE FOR IMPORT OF LIQUEFIED NATURAL GAS.

"(a) GENERAL RULE.—Notwithstanding section 2(21)(B) and subject to subsection (b), the just and reasonable rate for the acquisition of regasified imported liquefied natural gas by any natural gas company shall not exceed the average price for Number Six fuel oil during the most recent 90 day period for which data are available, as determined by the Secretary. The importation and transportation of regasified imported liquefied natural gas at any price in excess of the rate set by this subsection shall be unlawful, except as provided in subsection (b).

"(b) EXCEPTION.—Upon application to import liquefied natural gas under section 3 of the Natural Gas Act, the Commission and the Secretary may establish a just and reasonable rate for the acquisition of regasified imported liquefied natural gas by any natural gas company in excess of the average price for Number Six fuel oil during the most recent 90 day period for which data are available, as determined by the Secretary, if they determine that—

"(1) alternative domestic supplies of natural gas are not available in the market to which such liquefied natural gas is proposed to be delivered for the period and in the volumes required at the proposed price;

"(2) the source of supply of such liquefied natural gas is reasonably secure from political and technical interruption; and

"(3) the agreement under which such liquefied natural gas is supplied includes a provision for reducing the quantity of such imports or reducing the price of such imports, or both, if circumstances change such that alternative domestic supplies at reduced prices become available.

"(c) For the purposes of this Section, "Natural Gas Company" means natural gas company as defined in Section 2(6) of the Natural Gas Act.".

SEC. 2. This Act shall become effective immediately upon enactment.

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II

98TH CONGRESS
1ST SESSION

S. 689

Entitled the "Natural Gas Policy Act Amendments of 1983".

IN THE SENATE OF THE UNITED STATES

MARCH 3 (legislative day, FEBRUARY 23), 1983

Mr. HEINZ introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

Entitled the "Natural Gas Policy Act Amendments of 1983".

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS

(a) SHORT TITLE.—This Act may be cited as the "Natural Gas Policy Act Amendments of 1983".

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Sec. 204. Amendments to section 601 of the Natural Gas Policy Act of 1978.

TITLE I—FINDINGS AND PURPOSES

SEC. 101. The Congress finds and declares that—

(1) Natural gas is a fuel widely used in residential, industrial and commercial applications and significantly affects interstate commerce;

(2) There presently exists a surplus of deliverable natural gas;

(3) Natural gas prices are currently above market-clearing levels in many markets;

(4) Wellhead prices of natural gas are not responding promptly to retail market conditions;

(5) Take-or-pay clauses in wellhead gas purchase contracts are causing gas pipeline companies to incur substantial payment penalties and to purchase a mix of higher cost supplies than otherwise necessary;

(6) Indefinite price escalation clauses in wellhead gas purchase contracts steadily increase gas prices with little or no relationship to retail market conditions and are likely to increase prices significantly above market-determined prices if not controlled;

(7) Take-or-pay and indefinite price escalation clauses are causing or will cause results contrary to the public interest;

(8) Natural gas companies, as defined by the Natural Gas Act of 1983, have inadequate incentive to

control purchased gas costs in view of section 601(c)(2) of the Natural Gas Policy Act of 1978;

(9) Gas producers and pipeline companies are unlikely to renegotiate their gas purchase contracts to resolve the problems extant today in the natural gas industry; and

(10) Urgent legislative action is necessary to achieve wellhead gas prices responsive to retail market conditions.

SEC. 102. The purposes of this Act are to—

(1) Provide mechanisms for a smooth transition to the ultimate decontrol of certain wellhead natural gas prices;

(2) Assure that natural gas companies are held accountable, through Federal regulation, for all costs incurred by such companies, including purchased gas costs;

(3) Provide technical amendments to the Natural Gas Policy Act of 1978;

(4) Nullify certain gas purchase contract provisions which inhibit the free flow of market signals between consumers and producers of natural gas;

(5) Provide in certain wellhead gas purchase contracts market-out clauses to permit price adjustments in response to market conditions;

(6) Assure gas supply security to interstate markets;

(7) Assure that natural gas of marketable quality is received in return for maximum lawful prices; and

(8) Exercise the power of Congress to the maximum extent to regulate interstate commerce in the public interest.

TITLE II—AMENDMENTS TO THE NATURAL GAS POLICY ACT OF 1978

SEC. 201. Section 2 of the Natural Gas Policy Act of 1978 is amended—

(1) by inserting at the end of section 2(30), the following:

"For purposes of determining the number of Btu's per unit volume of natural gas, the Btu content of one cubic foot of natural gas shall be the number of Btu's produced by the combustion, at constant pressure, of the amount of gas which would occupy a volume of one cubic foot at a temperature of 60 degrees Fahrenheit, saturated with water vapor and under a pressure equivalent to that of 30 inches of mercury at 32 degrees Fahrenheit, and under standard gravitational force (980.665 centimeters per second squared) with air of the same temperature and pressure as the gas, when the products of combustion are cooled to the initial temperature of the gas and air and when the water formed by combustion is condensed to the liquid state; *Provided, however,* That a different method for determining Btu's may be used whenever any contract for the first sale of natural gas expressly and specifically by its plain language so provides."; and

(2) by adding at the end thereof the following:

"(38) DEFINITE PRICE PROVISION.—The term 'definite price provision' means any provision in a contract for the first sale of natural gas that establishes a specific unit price, which is known or predictable with certainty at any present and future time during the duration of the contract, for natural gas sold under such contract.

"(39) INDEFINITE PRICE PROVISION.—The term 'indefinite price provision' means any provision in a contract for the first sale of natural gas, other than a definite price provision, which establishes a price for natural gas sold under such contract.

"(40) MARKET-OUT PROVISION.—The term 'market-out provision' means a provision in a contract for the first sale of natural gas which permits either party in its sole discretion on 30 days notice to require the other party to accept a price different from the prevailing contract price as the contract price.

"(41) TAKE-OR-PAY PROVISION.—The term 'take-or-pay provision' means a provision in a contract for the first sale of natural gas which obligates the purchaser to take delivery of or to pay for an indicated percentage of natural gas under such contract.".

SEC. 202. Title I of the Natural Gas Policy Act of 1978 is amended—

(1) by adding at the end of paragraph 101(b)(9) the following: "The price under any contract in effect on November 8, 1978, shall remain the price after November 8, 1978, unless the contract expressly and specifically by its plain language authorizes prices established by Congress, in which case any price not in excess of the applicable maximum lawful price may apply."; and

(2) by adding after subsection 101(b) the following:

"(c) REPEAL OF ANNUAL INFLATION ADJUSTMENT FACTORS.—Upon the date of enactment of this Act, the annual inflation adjustment factor, as defined in subsection 101(a) and applied in sections 102, 103, 104, 105, 106, 107, 108 and 109, shall cease to apply.

"(d) COVERAGE OF CEILING PRICES.—

"(1) GENERAL RULE.—The applicable maximum lawful price for any first sale of natural gas shall be deemed to include all costs necessary to, or associated with, the delivery of marketable natural gas to the purchaser.

"(2) SELLER ALLOWANCE OR ADJUSTMENT.—To the extent that the seller incurs costs necessary to deliver natural gas of marketable quality to the purchaser and such costs deprive the seller of the opportunity to earn a just and reasonable return within the applicable maximum lawful price, the Commission may exercise its authority pursuant to sections 110 and 502(c) to provide an allowance or adjustment to the maximum lawful price which will permit the seller to earn a just and reasonable return.

"(3) PURCHASER ADJUSTMENT.—The Commission shall reduce any applicable maximum lawful price by the value of any consideration of any kind which the purchaser provides to the seller in addition to the applicable maximum lawful price. Such reduction shall include, but not be limited to, the value to the seller of any free or below-value transportation of liquid or liquefiable hydrocarbons provided by the purchaser.".

SEC. 203. Title III of the Natural Gas Policy Act of 1978 is amended—

(1) by deleting "." at the end of paragraph 311(a)(1) and inserting the following: ": *Provided, how-*

ever, That the just and reasonable rate shall be no less than $0.05 per million Btu's and that all revenues received by the interstate pipeline in excess of $0.05 per million Btu's shall be credited back to the customers of such pipeline."; and

(2) by adding at the end thereof the following:

"SEC. 316. FIRST SALE CONTRACTS AND PROVISIONS THEREOF.

"(a) INDEFINITE PRICE PROVISIONS.—Indefinite price provisions in all contracts for the first sale of natural gas are null and void as contrary to public policy.

"(b) MARKET-OUT PROVISIONS.—All contracts for the first sale of natural gas enumerated in subsections 121(a) (1) and (2), 121 (b) and (c) are deemed by operation of law to include a market-out provision.

"(1) EXERCISE BY PURCHASER.—The exercise of a market-out provision by the purchaser shall authorize the seller to seek an alternative purchaser. At the conclusion of the 30 day notice period, the seller shall either accept as the contract price the price offered by the purchaser or offer to the purchaser a right of first refusal at the price which the seller has negotiated with an alternative purchaser.

"(2) EXERCISE BY SELLER.—The exercise of a market-out provision by the seller shall require the seller to offer to the purchaser a right of first refusal at the price which the seller has negotiated with an alternative purchaser.

"(3) TRANSPORTATION SERVICE AND RATES.—Any pipeline purchaser which declines an offer made pursuant to any right of first refusal required by this subsection shall transport the natural gas involved on a best efforts basis on behalf of the seller. The rate charged for such transportation service shall be the rate agreed to by the seller and the pipeline purchaser or, if no rate is agreed to, the rate established by the appropriate State or Federal regulatory authority, *Provided, however,* That no State or Federal regulatory authority may establish a rate less than $0.05 per million Btu's plus the cost of such transportation and that all revenues received by a pipeline purchaser in excess of $0.05 per million Btu's shall be credited back to the customers of such pipeline.

"(c) TAKE-OR-PAY PROVISIONS.—Take-or-pay provisions in all contracts for the first sale of natural gas in effect on the date of enactment of this Act shall be deemed by operation of law to be limited to 50 percent.

"(d) RIGHTS OF PURCHASER TO CONTEST.—Any provision of any contract for the first sale of natural gas which has the effect of restricting the right of the purchaser to contest in any manner the rights and obligations of the parties to such contract shall be null and void as contrary to public policy.

"(e) ACCESS TO CONTRACTS.—All contracts and ancillary agreements for the first sale of natural gas shall be filed with the Commission and made available by the Commission to the public in an orderly manner within 60 days after the later of the date of enactment of this Act or the execution of the contract.

"(f) COORDINATION WITH EXISTING CONTRACTUAL PROVISIONS.—Any provision of any contract for the first sale of natural gas which would affect the rights and obligations of the parties to such contract as a consequence of this section shall be null and void as contrary to public policy to the extent such provision is inconsistent with this section or would cause termination of the contract.

"(g) CONTRACT INTERPRETATION.—On petition by any party to a contract for the first sale of natural gas or by any local distribution company affected by such contract, the Commssion shall have jurisdiction to resolve any matter concerning the rights and obligations of the parties or any other matters involving the interpretation of contract language.".

SEC. 204. Section 601 of the Natural Gas Policy Act of 1978 is amended to add the following:

"(d) EFFECTIVENESS OF NATURAL GAS ACT.—Notwithstanding any other provision of law, the authority of the Commission pursuant to sections 4 and 5 of the Natural Gas Act shall be in full force and effect with respect to natural gas companies, as defined in such Act, including, without limitation purchased gas costs incurred by natural gas companies.

"(e) RATE INCREASE DISINCENTIVE.—

"(1) PURPOSE.—The purpose of this subsection is to establish a mechanism to discourage natural gas companies, as defined in the Natural Gas Act, from making repetitive or excessive rate increase filings.

"(2) COMMISSION RULE.—Within 90 days after the date of enactment of this Act, the Commission shall promulgate a final rule which establishes the interest rate at which refunds shall be paid by natural gas companies on any collections made by such companies in excess of rates approved by final order of the Commission.

"(3) MINIMUM INTEREST RATE.—The interest rate established by the Commission pursuant to this subsection shall be no less than 3 percentage points above the prime interest rate prevailing during the period of any collections subject to refund made by any natural gas company.

"(f) TARIFF STUDY.—Within 1 year after the date of enactment of this Act, the Commission shall undertake and complete a comprehensive study of minimum bill and related provisions in interstate pipeline tariffs. The study shall—

"(1) include analyses of the effects of such provisions on the responsiveness of wellhead gas prices to retail market conditions, the rates charged customers of interstate pipelines, the ability of local distribution companies to secure varied sources of gas supply, and the present and future financing of existing and new interstate pipelines;

"(2) include analysis of the necessity for such provisions; and

"(3) be undertaken with opportunities for written and verbal comments of interested parties.

Pursuant to the Natural Gas Act, the Commission may, as appropriate, require the revision of minimum bill and related provisions in interstate pipeline tariffs. Nothing in this subsection shall preclude the Commission from ordering appropriate revisions to interstate pipeline tariffs during the pendency, or after the completion, of the study required by this subsection.".

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The CHAIRMAN. Senator Johnston, do you have a statement you'd like to make?

STATEMENT OF HON. J. BENNETT JOHNSTON, A U.S. SENATOR FROM THE STATE OF LOUISIANA

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Chairman, when we completed the Natural Gas Policy Act in 1978 some called it the end of the Thirty Years War. I hope that this is not the opening gun today in the new Thirty Years War, but rather I hope it is the first peace signal in a new era of tranquillity in natural gas pricing.

Hope springs eternal in the human breast, I guess. But Mr. Chairman, the Natural Gas Policy Act of 1978 was very much like the Treaty of Versailles after the First World War. It was a lot better than a continuation of the war, but we redrew the map in such a way that it guaranteed a new conflict. And indeed, we are in a new conflict. We are experiencing new problems caused by that Natural Gas Policy Act. Some call it Rube Goldberg's Policy Act, and indeed, in some respects it is.

For example, in my State of Louisiana, which is the largest producer of natural gas in the country, we sell some gas to other States at 29 cents an Mcf. At the same time, we're importing Canadian natural gas at $6.05 an Mcf, so we're paying 20 times as much as we get for the gas we export. In the meantime, cheaper natural gas is shut in around the country and the result is that the consumer, not only in my State but elsewhere around the country, is getting it in the neck because he's not only getting gas that increases in cost every year, but gas that is more expensive than it needs to be. That is the key to this whole legislative dilemma: It's not whether gas is going up in cost—we know that it is going to go up in cost as the expense of finding it increases—the key is does it cost more than it needs to?

Under this Rube Goldberg law we have 23 categories, with some selling for as little, as I say, as 29 cents, some selling for as much as $9.50 to different consumers in different areas. The categories were made without selection or merit or need or logic, but simply by the roll of the dice when that gas was found. And in the process, some formerly intrastate pipelines are selling gas for about a dollar more per Mcf on the average than are interstate pipelines. In some pipelines there's a discrepancy in cost of over $20.

Now, the system, Mr. Chairman, does not encourage competition among pipelines, nor can they even compete with alternate fuels. They must sell at the system average cost. So what you have is a vicious cycle. If the cost goes up too much, the alternate heating fuel, which is usually a No. 6 fuel oil, is less expensive so they shed loads from natural gas to go to competing fuel, which in turn raises cost to consumers, which in turn raises the average cost of the pipeline. And it's a vicious cycle where the consumer, particularly the residential consumer, gets it in the neck.

This is not the traditional split, or at the least the same split that we had in 1978 between this monolithic industry on the one hand—which included producers, both independent and majors, and the pipelines and the distribution companies and everybody that has anything to do with petroleum in one camp—and another camp neatly labeled consumers.

This is no longer that kind of split. Those who have a knee-jerk reaction to this as consumer versus producer I submit are not seeing the present law in its proper context and do not understand what is happening around the country in natural gas.

There is, indeed, a great split within the gas industry and many vested interests are affected by this bill. Some in the industry oppose it, some are for it. There are some producers who are independent who strongly oppose the bill, some who are for it; some majors are undecided, some are for it, and I guess some are against it. Pipeline companies take every conceivable position. And I am sure we're going to have facts that are dealt with very lightly as far as the truth is concerned as we consider this bill, not only because there will be an attempt to distort, but there will no doubt be a basic misunderstanding of the facts.

So I urge all parties to consider the facts. Present law, even if protected in the name of the consumer, would guarantee that we would perpetuate a system that has distortions, and built-in inefficiencies. It guarantees a lack of competition, therefore, a lack of supply, and ensures that prices will be higher than necessary to the consumer.

Now, Mr. Chairman, having identified these problems, I do not immediately embrace in all its provisions this new administration gas bill. I do greatly commend Secretary Hodel for coming up with highly inventive and creative bill which I think is a grand step forward which I think will and can serve as the framework for a new law.

It does have, I think, a couple of—more than a couple—but a few principal serious problems which we will discuss in greater detail as these hearings go on. Those problems are generally called the gas cap, and the passthrough. Those two problems, it seems to me, guarantee that the purpose of the law will be frustrated and that you will create situations for a new fly up come January 1, 1986.

But I think those two problems can be solved, not by junking the basic framework of the bill, but by some corrections which preserve the basic integrity of the bill while at the same time doing away with this problem of a new fly up, and make it more mechanically workable in this bill.

Mr. Chairman, I come to these hearing very hopefully, with a heart full of praise for the Secretary, but at the same time, recognizing that there are problems which must be solved. I am enthusiastic and optimistic about our chances meaningful legislation.

The CHAIRMAN. Thank you, Senator Johnston.

[The prepared statement of Senator Johnston follows:]

STATEMENT OF SENATOR JOHNSTON
COMMITTEE ON ENERGY AND NATURAL RESOURCES
MARCH 9, 1983

Mr. Chairman, today marks the beginning of a process I have long advocated. We are about to undertake a serious, comprehensive review of the many problems which plague our natural gas market, along with proposed solutions to those problems.

It has been almost two years since some of us began to point out the many pitfalls which lurked in the Natural Gas Policy Act. Today's market bears witness to our predictions, and if anything indicates that we underestimated the degree of the problem. Two years ago we were in an expanding market in which we pointed to market distortions and the possibility of extraordinary price increases. Today we are experiencing a market surplus in which the market distortions remain and the extraordinary price increases have become a reality. Such is the inevitable consequence of an Act which creates more than twenty different categories of gas, assigns a different price to each and then distributes them disproportionately.

Mr. Chairman, the problems in the natural gas market are extremely complicated, and one's proposed solution to them often varies depending upon one's unique position in the marketplace. Yet, two things are clear. The first is that virtually no one is satisfied with the status quo. The second is that any solution to these problems must be a comprehensive solution designed to remedy all of the problems we are experiencing. Quick fixes and partial solutions only serve to further compound the distortions already present.

In this light, any solution must be designed to bring all gas out from under wellhead price controls as quickly and as smoothly as possible. Anything less serves only to perpetuate existing inequities while giving rise to new ones. If the current market teaches us anything it is that a market in which wellhead prices are only partially decontrolled is a market destined for failure. How else can we explain increased prices in the midst of surplus. How else can we explain average costs which are almost twice as high in some regions as in others. And, how else can we explain the fact that some pipelines are unable to compete with residual crude oil when residual crude oil is a decontrolled commodity. There is no other explanation, and I fear that the current situation is but a hint of what awaits us in 1985.

If we are to avoid the inevitable hardship of 1985, we must act quickly and responsibly to bring all gas out from under wellhead price controls.

I wish to commend Secretary Hodel and the Administration for their recognition of this fact. While I am concerned that certain provisions of S. 615 would prevent full decontrol from proceeding as smoothly as is desirable, I welcome the bill as the framework with which we can work to achieve a total solution. Having undergone the process of piecing together such a proposal just last year, I am painfully aware of how difficult it can sometimes be. Mr. Secretary, you are to be congratulated for having undergone this process, and for having survived it so well.

Natural gas pricing is a uniquely complicated, sometimes emotional and always political subject. But it is one which we can avoid no longer. I look forward to these hearings and to working with the members of the Committee on this issue.

The CHAIRMAN. Senator Heinz.

STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator HEINZ. Mr. Chairman, thank you very much. Let me thank you at the outset for including S. 689 as one of the subjects for discussion during these 4 days of hearings.

As the committee begins consideration of comprehensive natural gas legislation intended to correct certain glaring deficiencies in the Natural Gas Policy Act I reflect on the fact that principally as a Senator I represent a natural gas consuming State, and as such I am only too well aware of the impact that rising natural gas prices have had.

For example, there are some 350,000 Pennsylvanians, families, families mind you, who fall below 120 percent of the poverty level, the financial dividing line for most Federal programs. That line comes to $418 per month on which to live. The result is, that after spending money for rent, for the nonheating electric utility bill, food, and finally the gas bill, the average family of three will find itself $33 in debt.

So many Pennsylvanians, indeed, many people all across this Nation, are going to be faced with the choice of heating or eating this year. And I might add, Mr. Chairman, that the Senate Special Committee on Aging, which I am privileged to chair, will be holding a hearing on the subject of how our Nation's elderly are being effected by the kind of natural gas price increases that we've experienced.

Before I go into any detail on legislation and the remedies I believe are required to address some of these problems, I'd like to first review the climate under which the NGPA was passed in 1977, and the deficiencies that have come to light after 5 years of its operation.

I think we would all agree that fundamental to the NGPA was a balanced approach to the twin objectives of consumer price protection and adequate price incentives for vigorous domestic gas supply development. The NGPA established an incentive price for new gas supplies and retained controls on the old gas.

We enacted the NGPA in 1978—and I supported it—pursuant to the best political wisdom and political climate then prevailing.

Since 1978, however, a series of conditions have arisen which we could not have anticipated then, but which now combine to require our action once again in this most controversial and exceptionally complex area. For example, the NGPA did not anticipate dramatic increases in oil prices, or the Federal Energy Regulatory Commission's self-enforced abdication of its traditional consumer protection role.

The events have been compounded by certain deficiencies within the NGPA itself. By providing interstate pipeline companies with a guaranteed passthrough of their purchased gas costs NGPA itself greatly reduced the institutional incentive of those companies, pipeline companies, to drive hard bargains with the gas producers and to control reasonably their purchased gas costs.

I believe it's fair to say that almost all gas consumers, utilities, pipelines, and producers, as evidenced by some of the statements we've heard so far today, agree that something must be done. The real question is what?

The administration has proposed to address four significant goals: To correct certain defects in the NGPA, to protect gas consumers from price increases, to provide a free market for natural gas, and to permit natural gas contracts to reflect changes caused by the transition from a regulated market to a free market.

I don't believe that those objectives can be achieved, even if one were to support all of them, under the provisions of the proposed legislation, S. 615.

First, the lynchpin of the administration's proposal, the decontrol of old natural gas, can only result in significant price increases to the natural gas consumers of this country. Further, the decontrol of old gas prices could easily result in some future supply curtailments.

Second, S. 615 provides little relief for the onerous contract provisions now denying consumers access to the least expensive gas, and even this relief is only temporary, expiring on January 1, 1986.

Third, S. 615 fails to provide consumers with long-term protection against excessive guaranteed passthroughs by pipelines of their purchase gas costs. That is, S. 615 guarantees a return to a standard of pipeline regulation that's proven beyond any reasonable doubt to be an ineffective consumer protection device.

Mr. Chairman, to hopefully more fully address the problems of the Natural Gas Policy Act that are so clearly distorting the market price of natural gas, I introduced last Thursday, S. 689. I believe the legislation that I have introduced will achieve both consumer supply protection and consumer price protection.

Very briefly, and I won't go into a great deal of detail, but I would like to summarize that, first, my proposal will continue all existing controls on old gas while retaining the schedule for the decontrol of new gas mandated by the NGPA.

Second, my proposal will nullify indefinite price escalators in existing and future gas contracts, limit take or pay provisions in existing contracts to 50 percent, and mandate the existence of market-out provisions in all contracts for gas to interstate pipelines after 1977, with appropriate transportation provisions.

Third, this legislation requires the implementation of stringent pipeline accountability standards.

And fourth, consumer protection will be further achieved through a series of technical amendments.

These, and other features of my legislation, Mr. Chairman, will amount to upon enactment, according to the best estimates, a savings of $25 billion per year for gas consumers, a savings of $200 annually for residential gas consumers.

Mr. Chairman, let me say—for the average gas consumer, I should say—Let me say in closing I thank you. I thank the committee for scheduling these hearings to focus the attention of the Senate on this critical issue. And I am well aware, as you said at the outset, there is a tremendous division of opinion on this committee on what, if anything, ought to be done.

It is literally true that there are not only the voices, but I expect the vote to prohibit the administration's bill from going anyplace. I am all too well aware that the legislation I've introduced may be displeasing to producers or to consumers because it doesn't roll back the prices to 1978 like maybe some people would like to have us do, and it doesn't deregulate every single gas well in the country in 1985 or 1986 like some producers would have us do.

I do think that it is a balanced approach but I don't suggest that it is the only balanced approach. And hope to work with all members of the committee to get a solution to what is clearly a real problem. The real problem, so that nobody misunderstands it, is that the marketplace isn't working, prices of gas are higher than substitute fuels. And we are, as a result, not only causing our consumers to pay too much, but we're shutting producers out of the market who would like to be producing and a part of the market. That, it seems to me, is just about the worst of all worlds.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Senator Heinz follows:]

SENATOR JOHN HEINZ
STATEMENT BEFORE THE COMMITTEE ON ENERGY AND NATURAL RESOURCES, HEARING ON PENDING NATURAL GAS LEGISLATION
MARCH 9, 1983

Today, this Committee begins consideration of comprehensive natural gas legislation which is intended to correct certain glaring deficiences in the Natural Gas Policy Act (NGPA). As a Senator representing a major natural gas consuming state, I am only too well aware of the impact that rising natural gas prices have had.

--Between 1978 and 1981, the income of a Pennsylvania manufacturing employee increased by 30% while his natural gas bill increased by 127%.

--Between September of 1978 and and September of 1982, the gas rates charged by the six pipelines serving Pennsylvania increased by an average of 175.6% while the Consumer Price Index rose by only 47.2%.

--Between 1978 and 1982, gas prices charged to residential consumers in the city of Philadelphis increased by over 94% and in Pittsburgh by over 86%.

Many Pennsylvanians, and many people all across this nation, will be faced with the choice of heating or eating this year.

Over 350,000 Pennsylvania families fall below 125% of the poverty level, the financial dividing line for most Federal assistance programs. That line comes to $418 permonth on which to live. After spending money for rent, the gas bill, the nonheating electric utility bill and food, the average family of three will find itself $33 in debt every month.

Just as bad is the plight of the single elderly Pennsylvanian totally dependent on a maximum supplementary security income payment of $317.60 per month. After paying his or her natural gas bill, this elderly Pennsylvanian will be left with only $39 per week for all other living expenses. I intend to schedule hearings before the Senate Aging Committee to further investigate the severity of these price increases on theis Nation's elderly citizens.

On a nationwide basis, natural gas prices continue to rise by an average annualized rate of approximately 25.3%. In many parts of our Nation, this increase more nearly approaches a level of 40 to 50 percent. This has occurred despite the sizable present surplus of deliverable gas.

The facts I have just stated make it imperative that this Congress move expeditiously to take action to provide our country's citizens with the relief that they urgently need from excessive and unjustified gas cost increases.

But before I go into the remedies I believe are now required, let me first review the climate under which the NGPA was passed in 1977, and the deficiencies that have come to light after 5 years of its operation. After very long and arduous deliberations in the 92nd, 93rd, and 94th Congress, the 95th Congress passed and the President signed into las the Natural Gas Policy Act of 1978. Fundamental to the NGPA was a balanced approach to the twin objectives of consumer price protection and adequate price incentives for vigorous domestic gas supply development. The NGPA established an incentive price for new gas supplies with the ultimate decontrol of most of that gas by January 1, 1985. Further, NGPA retained controls on old gas both to assure consumers the price benefits of that gas and to provide additional incentives to producers for new gas exploration. We enacted NGPA in 1978 pursuant to the best wisdom andpolitical climate prevailing at that time.

Since 1978, however, a series of conditions have arisen which we could not have anticipated then, but which now combine to require our action once again in this most controversial and complex area. For example, the NGPA did not anticipate dramatic increases in oil prices, or the FERC's self-enforced abdication of its traditional consumer protection role. Moreover, NGPA did not anticipate the magnitude to which interstate pipelines and gas producers would seek to increase gas prices by thier contracts now and at the time of decontrol of new gas in 1985. High take-or-pay and indefinite price clauses in those contracts are causing gas gas prices to the consumer to be higher than necessary, creating grave consequences for consumers and the gas industry alike in 1985 if not restrained.

The events have been compounded by certain deficiencies within the NGPA itself. The NGPA category pricing mechanisms have proven to be highly inflexible and one-way---up. Wellhead prices responsive to retail market conditions have been virtually impossible to achieve even at this time when supply is clearly inexcess of demand. Moreover, by providing interstate pipeline companies with a "guaranteed passthrough" of their purchased gas costs, NGPA itself greatly reduced the institutional incentive of those companies to drive hard bargains with the gas producers and to control reasonably their purchased gas costs.

I am hardly the first person to notice or point out these inadequacies in the legal and institutional framework surrounding gas prices. Indeed, many of us have already addressed in some fashion most of the concerns I am expressing today. And I believe it is fair to say that almost all gas consumers, utilities, pipelines, and producers agree that "something" must be done. The real question is what?

The administration has porposed to address four worthwhile goals: to correct certain defects in the NGPA, to protect gas consumers for price increases, to provide a gree market for natural gas, and to permit natural gas contracts to reflect changes caused by the transition from a reulated market to a free market. However, I do not believe that these objectives can be achieved under the provisions of the proposed legislation, S. 615.

First, the lynchpin of the administration's proposal, the decontrol of old natural gas, can only result in significant price increases to the natural gas consumers of this country. It has been estimated that the residential gas bills will increase by 67%, adding over $50 billion to the gas bills of consumers nationwide. Further, the decontrol of old gas prices could easily result in future supply curtailments, because we would be eliminating the incentive needed for producers to find new gas supplies in order to insure the long term security of gas supplies.

Second, S. 615 provides little relief for the onerous contract provisions now denying consumers access to the least expensive gas, and even this relief is only temporary, expiring on January 1, 1986. Under the terms of this proposed legislation, neither take-or-pay clauses nor indefinite price escalators are addressed to achieve real protection for consumers. Consumers will be assured of only one thing -- that their gas bills will continue to go up, regardless of supply or market conditions.

Third, S.615 fails to provide consumers with long term protection against excessive guaranteed passthroughs by pipelines of their purchase gas costs.

On January 1, 1986, the standard of regulation of interstate pipeline purchased gas costs returns to the "fraud, abuse, or similar grounds" provision of NGPA section 601(c)(2). That is, S. 615 guarantees a return to a standard of pipeline regulation which has proven beyond any reasonable doubt to be an ineffective consumer protection device.

In the near term, the legislation's attempt to provide relief from excessive purchase gas cost increases may be illusory. It bases increases on accepting the most recent purchased gas passthrough prior to enactment as as just and reasonable, though this may not be the case at all. There is therefore no guarantee that excessive, unreasonable passthroughs will not be the basis for future price increases. In this way, consumers may continue to be abused by irresponsible pipeline purchasing practices.

Mr. Chairman, I believe the legislation that I have introduced will achieve both consumer bupply protection and consumer price protection, and that it will provide a permanent and comprehensive, and workable, solution to the serious problems confronting gas consumers and the gas industry today.

First, my proposal will continue all existing controls on old gas while retaining the schedule for the decontrol of new gas mandated by the NGPA. This strategy protects the consumer from increases in the price of old gas, which constitutes more than 40% of existing supplies, while providing incentives necessary for secure, long-term gas supplies.

Second, my proposal will nullify indefinite price excalators in existing and furture gas contracts, limit take-or-pay provisions in existing contracts to 50%, and mandate the existence of market out provisions in all contracts for gas to interstate pipelines after 1977 with appropriate transportation provisions.

These provisions will provide access to low-cost gas, currently denied to consumers by abusive contract provisions and will serve to eliminate non-market related increases.

Third, this legislation, in order to put to an end the abusive pipeline purchasing practices, requires the implementation of stringent pipeline accountability standards outlined in sections 4 and 5 of the Natural Gas Act Also, a penalty would be established which requires pipeline companies to pay interest on refunds of any excess rate collections charged customers at 3 percentage points above the prevailing prime rate.

Fourth, consumer protection will be further achieved through a series of technical amendments relating to determining the Btu content of natural gas, clarifying that contract authority is a necessary precondition for the collection of NGPA ceiling prices, and reaffirming that NGPA ceiling prices cannot be exceeded either by noncost based production-related allowances or by pipelines providing other below value services to producers while also paying NGPA price.

These, and other features of my legislation, will amount to, upon enactment, a savings of $25 billion for gas consumers, a savings of $200 annual saving for residential gas consumers per year.

Mr. Chairman, let me say in closing, that I thank the Committee for scheduling these hearings to focus th attention of the Senate on this critical issue. And although I have expressed my disagreement with the provisions of the administration's proposal, I join in those consumer protection goals and provisions that the administration has included in its proposal, and it is my sincere hope that the members of this Committee and the administration can work together in framing legislation which will benefit the nation and its citizens.

The CHAIRMAN. Senator Jackson.

STATEMENT OF HON. HENRY M. JACKSON, A U.S. SENATOR FROM THE STATE OF WASHINGTON

Senator JACKSON. Mr. Chairman, I'm pleased to join my colleagues in welcoming Secretary Hodel to today's opening round of hearings on pending natural gas legislation.

At the outset, I want to congratulate the Secretary on his success in persuading the President and his advisers to take a realistic look at the natural gas issues facing the Nation today. The administration's bill is a far cry from the approach recommended in the past by the Cabinet Council on Natural Resources and Environment. It's obvious to me and to everyone else in this room that a reasoned, pragmatic approach has replaced an ideological, rhetorical one.

Let me hasten to add that my comments do not mean that I endorse the legislation. Many, many questions must be asked and answered satisfactorily before I will endorse this or any other bill. I suspect that a majority of my colleagues on this committee feel the same way.

It is easy to poke holes in the Natural Gas Policy Act. With the benefits of 20/20 hindsight, I, too, wish that we had done a few things differently. As a matter of fact, it doesn't take hindsight to wish we'd done things differently. I personally would have done quite a few things differently if I had had the votes. But the simple fact of the matter was that the bill represented the best compromise we could develop and pass at the time.

The vital question before this committee today is whether new legislation would be a net improvement over the existing law, or whether we would be substituting a new set of problems, and inequities, for an old one. The burden, it seems to me, must be on those who want to amend the law to convince us that their approach would be better for all concerned.

Mr. Chairman, I have many questions about the bill. A few of the more important issues come to mind:

What public interest is served by raising the price of all old, flowing natural gas?

What will be the long-term supply response if we deregulate old gas? Without the roll-in capacity of old gas, will we be able to afford to explore and develop some of the more promising areas which are particularly expensive to develop?

How will independent analysts answer the question of whether deregulation of old gas will mean more expensive supplies in the future?

How will natural gas utilities—both pipelines and local distribution companies—be able to meet their utility obligation to serve the public if the contracts underpinning their basic source of supply cannot be relied upon?

Do the marketplace principles behind many of the provisions in the administration bill have any place in the public utility business?

Will limited deregulation and freer access for natural gas pipelines work well, or will it work like the airline industry, where large cities have frequent, relatively inexpensive service while small out of the way communities suffer?

Will our progress toward a national natural gas market be stopped by the market-out and the cap provisions in the administration bill? If we have a resurgence of our economy, will those provisions mean that only the old intrastate market will be able to buy gas?

Finally, Mr. Chairman, and perhaps most importantly, does the Administration bill really protect natural gas consumers, particularly residential and shall business consumers, from unwarranted price increases?

Mr. Chairman, I hope that no one in this room thinks the answers to those questions will be easy to find. I can tell you from long experience that they will not be. Mr. Chairman, they must be answered satisfactorily before we should proceed.

Thank you.

The CHAIRMAN. Thank you very much, Senator Jackson.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman, I'm just waiting to hear our superstar. Thank you.

The CHAIRMAN. Thank you.

Senator Ford.

Senator FORD. Mr. Chairman, just a moment ago the distinguished Senator from Louisiana said that it's the end of the 30-year war and it looks like we might be starting another one. I might just remark that the debate on the floor and the filibuster seemed like a 100-year war. And if there's any indication at all in the interest that's in this room today and the lengthy statements by our colleagues, if it's any indication, I believe we're going to have a 150-year war.

And so in order to maybe get to Secretary Hodel before midafternoon, I'm going to yield my time to him.

The CHAIRMAN. Senator Metzenbaum.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. Mr. Chairman, I'd like to first commend Secretary Hodel for making a genuine and honest effort to redress the current problems in the Nation's natural gas market. Unfortunately, the administration's bill will not provide any relief to homeowners buffeted, battered and brought to their knees by soaring natural gas prices over the last 2 years.

The Hodel bill is offered as a sensible way to control a runaway market. In reality, it turns logic on its head and defies economic reason.

The administration has called the bill the natural gas consumer regulatory reform legislation. The administration ought to be sued by the Federal Trade Commission for false and deceptive advertising. It can put the word "consumer" in the title, but it won't alter one indisputable fact: decontrol is decontrol is decontrol. And decontrol means higher and higher prices for the consumer.

There are only two sure things about this bill. First, the pockets of the American consumer will be fleeced by tens of billions of dollars. Second, it will result in staggering windfall profits for the Nation's major oil companies.

In fact, a more apt title for this legislation would be the "Big Oil Giveaway Act." The plan to deregulate old, cheap gas supplies, three-quarters of which are held by the top 20 oil companies, would result in a $40 to $68 billion windfall to big oil.

Decontrol will be great for Exxon and Mobil. But it will devastate the American consumer. Make no mistake about it: This bill will cost consumers dearly. The price tag may ultimately be $60 billion a year if we accept the word of a gas industry chief executive. In the end, consumers will become unwilling partners in what may turn out to be the greatest transfer of wealth in this country's history.

The administration and industry have said decontrol would lower prices. But we've heard that before. They weren't telling the truth then and they aren't telling the truth now.

In 1978 we passed the Natural Gas Policy Act. I opposed it at the time. It was a bad bill. But the industry supported it. The industry said, "Give us phased decontrol and price increases will not exceed 8 percent a year. Eight percent a year and supplies will multiply." So they got their bill. And lo and behold, huge quantities of gas suddenly appeared as producers released supplies they had been withholding.

The Secretary of Energy told us all of a sudden there was a balloon, there was a glut. The glut has remained. Today we have a surplus. But what happened to prices? Residential prices have soared 114 percent in 4 years, not including the 20- to 60-percent increases that floored millions of homeowners this winter.

This administration has taken the old decontrol argument one step farther than its predecessors: "Give us decontrol," they say, "prices won't rise, they will actually fall." This is the same industry that once claimed that prices would fall when supply was plentiful. But now it is plentiful and prices continue to rise.

Now they would have us believe another odd economic theory. If you allow prices to rise, consumers will pay less. I suggest that anyone who believes this bill will result in lower natural gas prices is literally living in a dreamworld.

There are several reasons why the Hodel bill is bad for consumers. First, it would result in total decontrol in 1986. Current law provides a cushion against the impact of decontrol by leaving controls on old, cheap gas. The Hodel bill strips the cushion away. It guarantees a hard landing for consumers.

There is no justifiable reason for freeing old gas from controls. The gas is cheap to recover, it's flowing, and will continue to flow. The producers have already recovered their investments and are making money.

Allowing them to recover higher prices would be tantamount to a staggering, unearned windfall. I say enough is enough.

How much of a windfall? I believe it easily could reach $40 to $68 billion just for the top 20 oil companies alone. That does not even tell the whole story. There's about 57 trillion cubic feet of old gas reserves dedicated to interstate pipelines. When you include this gas in the windfall equation, depending upon your assumptions, you see an additional $86 to $172 billion windfall for big oil. Not one penny of that will have been earned.

The administration says that lower prices will result from downward renegotiation of existing contracts. There is not a shred of evidence that this would occur. Indeed, the evidence that does exist compels precisely the opposite conclusion: Renegotiation will drive prices higher, not lower.

There are no real incentives for renegotiation downward. There are plenty of incentives for renegotiation upward. For example, pipelines with cheap, old gas contracts may decide to renegotiate these prices higher immediately rather than risk seeing the producer market-out in 1985 and dedicating the gas elsewhere.

But producers are not likely to negotiate downward. That is contrary to every accepted business norm. People try to get more for their product. They do not come in and say "Give me less." Practically speaking, old gas producers will either immediately receive higher prices or they will refuse to renegotiate, knowing full well that on January 1, 1985 under this bill, little more than a year after this bill passes, if it eventually does, they would be able to market-out.

Now let me highlight another problem. The administration says that fear of price increases are unwarranted for two reasons: First, the bill contains a cap to control prices. You and I have discussed that, Mr. Secretary. Second, the Federal Energy Regulatory Commission will guard against excessive price rises.

So-called gas cap, in fact offers only a false sense of protection. First of all, it does not apply to renegotiated contracts by the terms of the bill itself. They can rise to whatever levels are agreed to by the parties. And second, since new contract prices will be used in computing the cap it is quite possible that the cap will be set at an extremely high level in the first place.

Now what about FERC? I suggest that entrusting the fate of consumers to FERC, the Federal Energy Regulatory Commission, is like asking the fox to guard the chicken coop. Indeed, FERC is the chief cause of the recent price rises by virtue of its singleminded pursuit of regulations driving prices upward.

In case after case it has granted producers higher prices, leading to billions in unjustified charges to consumers. It ruled that area rate clauses could be triggered by new NGPA ceilings. It allowed producers of tight sands gas to charge exorbitant prices. It changed the definition of a Btu of gas. It expanded the definition of stripper well gas. And it allowed producers of offshore gas in areas deeper than 300 feet to charge twice the price of section 103 gas.

And most significant of all, it issued an absurd and indefensible ruling on the meaning of the section 601(c)(2) passthrough standard. That ruling has, more than any other single fact, caused the tremendous run up in prices these past two winters.

But why did we expect anymore? Or how could we in the future hope to expect any more protection from a five-member commission, three of whom come from the producing States of Texas and Louisiana. Its chairman wrote the Republican Party platform calling for total and immediate deregulation in 1980. There are no members on that commission from the major consuming States in the Northeast and Midwest. Is this the agency which is going to give consumers a safe harbor from unjustifiable price increases?

The bill promises price reductions by reducing the take or pay requirements to 70 percent. That clause, too, is totally meaningless. Demand is soft today and the 70 percent that pipelines would be required to take would probably fulfill current demand. So there will be no price cut. Worse, the producer would be free to market the gas elsewhere, depriving the pipeline and the consumer of a future gas supply as producers dedicate the gas to other users.

There are some other problems with this bill which are lurking below the surface. Interstate pipelines will be subject to the FERC passthrough review. But intrastate pipelines and industrial users would not be. Thus, a dual market would be created where intrastate and industrial buyers would be free to tie up new gas supplies, placing interstate pipelines at a severe competitive disadvantage.

Now some people may have short memories. But I do not. I remember the insidious effect of the dual market, which only a few years ago caused an acute shortage in my State and many others and forced the shutdown of businesses and factories and created special problems even for hospitals.

I say to you, Mr. Secretary, I am pleased to see that you are making an effort to solve the problem of natural gas consumers. This bill will not solve that problem. I will use every tool in my disposal to defeat the bill. Its passage would make it impossible for the gas consumer to receive reliable service at the lowest possible cost. It would increase unemployment, it would bankrupt small businesses and farmers. It's bad legislation, it's bad for America. It will not pass if I can possibly stop it.

Thank you.

The CHAIRMAN. Senator Nickles.

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Mr. Chairman, I do want to thank you for scheduling these hearings to explore legislation concerning one of the Nation's most important resources: natural gas.

Throughout the last several decades, there has often been serious misunderstanding about how we can best utilize our energy resources. This misunderstanding has often resulted in misguided Government policies aimed at regulating these resources. The history of natural gas regulation is a perfect example of how Government interference first distorts, and then disrupts the process of fair, equitable, and productive utilization of our resources.

It is in this light, though, that I congratulate the Reagan administration, and particularly Secretary Hodel, for proposing legislation to deregulate natural gas. Their proposal is a very interesting attempt at balancing some of the concerns ofmost of the groups with an interest in natural gas. I believe we can use this proposal as a good starting point as we in Congress work to develop a bipartisan solution.

My views on the subject of natural gas are well known. I have been a vocal supporter of total and immediate decontrol of the natural gas industry.

There is no better regulator of our energy resources than the marketplace. The Government may think itself smarter than the free market, but history has proven otherwise.

During the debate over the decontrol of oil, supporters of big government continued to lash out against their constant denunciations of this administration for what they believed were policies that would devastate the American consumer. Numerous studies were released with a lot of fanfare, and a lot of statements saying that the price of gasoline would rise to unbelievable levels, to $1.50 to $2.

The statements were made that the big oil companies would be ripping off the American consumer and receiving billions of dollars. We have heard some of those statements today. Those statements that were made in regard to the deregulation of oil were wrong. The marketplace has proven that it can work and actually we have seen the decontrol of oil has greatly contributed to the decline of oil prices, and we have seen oil prices decline substantially and greatly contribute not an increase in the CPI but actually a decrease in the CPI in the last 2 years.

The problems in the natural gas industry during the last two decades were the result of Government intervention and regulation. It was Government regulation that caused massive curtailments and shortages in the natural gas markets in the mid-1970's.

And how did Washington respond to this situation? Basically, with more government. Congress created the Natural Gas Policy Act which may have eased earlier shortages but it also compounded the regulatory confusion and market dislocation.

In my State of Oklahoma, we have gas we cannot sell. We have some gas that sells for 20-some cents, and we have gas that sells for $9. We have 28 different price categories for the same product—natural gas. That is absurd. Just because the Government has been gumming up the basic laws of supply and demand.

Mr. Secretary, I want to thank you for making a strong commitment to returning the natural gas industry to the marketplace. Also, I would like to compliment you for, I think, the fine way that you have been presenting it, and the knowledgeable amount of homework that you have done in studying the very complicated subject.

I wholeheartedly support some portions of the administration's bill, particularly the repeal of the Fuel Use Act.

This one act has caused a considerable burden on the State of Oklahoma as well as all other States. Had Congress not amended the act in 1981, it would have cost Oklahoma consumers and utility payers really in the billions of dollars.

Really, in my opinion, unless the entire act is repealed it will continue to put an economic burden on both consumers and on the entire natural gas industry.

We need to allow industries and utilities to be able to burn natural gas. If they are forced, which is in the present law, under the Fuel Use Act, and that means that the consumer is going to have to pay a disproportionately higher and greater share of those fixed costs of transportation.

That is going to mean higher costs for utility payers and higher costs for residential users.

I am also pleased with the call for total deregulation on any new contract upon enactment of this legislation.

I do, however, have a few reservations about the proposal.

First, in my opinion, the legislation does not go far enough nor fast enough toward decontrol. The longer we maintain complicated regulations on natural gas, the harder it will be on the economy, on the consumer, and on the producer.

The "no flow through" provision keeps control on gas until January 1, 1986. I believe that both the consumers and the producers would benefit by a more rapid deregulation of all natural gas.

Second, I am also concerned about the way that private contracts are treated. Congress, in my opinion, must tread very softly on the issue of tampering with privately negotiated contracts. The root cause of today's natural gas problems are not the current contract; rather it is Government overregulation.

If we assume that private contracts are the problem, I am afraid that Congress will be timid in seeking a longlasting solution based on deregulation and instead merely force the rewriting of every contract not to Congress liking. This will be a very dangerous step, and I believe a giant step in the wrong direction.

Third, the proposed method of the calculation on the cap on natural gas prices may cause a very severe distortion of the market prices. Many believe the gas cap price would fall below the market price of gas and could actually force the producer to sell his gas for substantially less than what is stated in his present contract. The contract, I might add, is negotiated in good faith, and the contract is negotiated under the terms of the NGPA, and in total compliance with NGPA.

Many independent producers are highly leveraged at this time, any forced rollback in their prices could force them into bankruptcy.

In the current state of the natural gas industry, the current state of the oil industry, as alluded to by Senator McClure is down substantially.

In the State of Oklahoma we are running 32 percent of the rigs that we were running a year ago. That means two-thirds of the rigs are idle. That is a substantial reduction, so I am very concerned about this gas cap proposal and also the past two provisions that could have a very significant and, I think, negative impact on the production industry.

Further, I hope that the administration will address the potential problem that could and probably is being caused by the high priced imported natural gas, primarily Canadian, also Mexican and also LNG.

I would like to have the administration to address: Are these contracts regulated in the same manner as domestic contracts are regulated?

These are just a few of my concerns that I hope will be discussed among these hearings. I am pleased that the committee has agreed and will be holding hearings later this month in the State of Oklahoma on March 28 and 29, and invite all of my colleagues, those that have similar views or possibly different views to join with me on those hearings, to further explore all ramifications and effects of this proposal or any proposal dealing with natural gas.

All things considered, I do believe that total deregulation will be of considerable economic benefit to this country, and I hope that we will be able to move quickly on legislation designed to allow the marketplace to work, and I believe it will work in a fair and equitable manner for all.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Warner.

STATEMENT OF HON. JOHN W. WARNER, A U.S. SENATOR FROM THE STATE OF VIRGINIA

Senator WARNER. Mr. Chairman, I think it is important we get on with the hearing, but I would like to make just a brief observation and comment to my colleague from Ohio.

Wouldn't it be far better that we work in a bipartisan spirit to try and fashion a new law rather than just to defeat this one, as you have promised to do.

It seems to me that our State is experiencing, and other States, almost the situation of civil disobedience brought on by the disarray of the present law.

I bring to your attention the fact that many States and municipalities have passed laws and regulations curtailing the shutoff, pitting therefore law-abiding citizens against utilities, equally law-abiding, suppliers and otherwise, resulting in a loss of income to utilities, added costs in connection with the shutoffs and a hopeless situation in homes.

And many of the States, including mine, have recently run out of funds for the fuel assistance program, to help people in these areas, even though this committee inspired a law, which enabled the Secretary of Energy to disburse $200 million here in the last few months, to help that situation.

So, let's see what we can do to fashion a loose law.

Also, Mr. Secretary, I am concerned that the provisions in this proposal which would discourage the curtailment of oil, petroleum industry and switch to coal, so I will dwell on those provisions at a later time.

The CHAIRMAN. Thank you, Senator Warner.

Senator Bumpers.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator BUMPERS. Mr. Chairman, my mind is open on this bill, but just barely. I will just summarize a few thoughts. I have a formal statement, which I will put in the record.

The CHAIRMAN. It will be placed in the record.

Senator BUMPERS. But I would just like to raise these points that concern me.

First, Mr. Secretary, I am afraid that this bill is designed primarily to decontrol old gas, and that the rest is mostly window dressing.

Second, in the renegotiation of these contracts which is permitted under the bill, if a purchaser elects to market out, he may still be obligated to carry the amount of gas that he was obligated to carry under the contract for which he has just marketed out, which places some burden on him which I doubt very seriously he would want to assume.

Third, this bill repeals that part of the Fuel Use Act that restricts the use of natural gas to premium uses, which I have always strongly favored. It also repeals that part of the Fuel Use Act which gives the President or Congress the right to reimpose controls. We might answer that by saying Congress has the right to do anything it wants to anytime it wants to, but taking into consideration Senate procedures and how difficult it is to get anything done around here, that is not totally satisfactory to me.

Fourth, a lot of the arguments were made to support the NGPA which are now being made for decontrol.

It seems to me that we are always in the position of Charlie Brown around here—we buy the argument that Lucy is not going to pull the ball out from under him.

The arguments are always the same, but it seems that the consumer is always the one that gets kicked under these things.

I agree with Senator Metzenbaum on the fraud of putting the "consumer" in the title of this bill. That reminds me of the Economic Tax Recovery Act of 1981 which sent the economy of this country into a tailspin.

In this particular case, however, we have between 1 and 2 trillion cubic feet of gas shut in that is not now being marketed because there is no demand.

We also have the situation where the Natural Gas Policy Act sets a ceiling price on gas, and while there ought to be a market price, considering the fact that we have that much gas shut in, there ought to be a market price, but there is not.

The market price is the ceiling in every single instance. The only place where gas is bringing less than the ceiling allowed under the Natural Gas Policy Act is where it is already contracted for and the price is settled.

So, it is difficult for me to believe, since the administration makes no argument that this bill is going to produce more natural gas—maybe it does make that argument, but if we have a glut now, it is difficult for me to understand that unless you expect prices to rise.

But if you are not making the argument that this bill will produce more natural gas and we have a glut right now, it is difficult for me to believe that prices can possibly go down under this.

And, finally, I also worry about the possibility of the dual market—interstate and intrastate. One of the most compelling and persuasive arguments for the Natural Gas Policy Act in the first place was to get rid of the dual market between pricing, intrastate and interstate gas.

And I am afraid that we may wind up returning to that, even.

Mr. Chairman, I ask unanimous consent that my formal remarks be inserted into the record.

[The prepared statement of Senator Bumpers follows:]

Statement of Hon. Dale Bumpers, a U.S. Senator From the State of Arkansas

Mr. Chairman, I am pleased that you have called these hearings so this committee can examine the recent large increases in natural gas and take whatever action, if any, is necessary to solve this problem. In 1978, we approved the Natural Gas Policy Act which was designed to merge the price of natural gas with its oil equivalent by 1985. Indications are that the price at the burner tip is already approaching, or even exceeding, the market clearing price.

We should consider the full range of proposed solutions which have already been introduced as legislation. We should also consider all suggestions which are made during these hearings and during any committee action. We should not, however, assume that the solution either can or must be legislation. First, we must determine whether the nature and extent of the problem is such that it can be solved by administrative action.

Second, we must not cure one disruption by creating another. Our previous hearings on natural gas pricing and marketing have indicated that the problem arises from certain contacts which some pipelines have entered into. If that is the case, then it is possible that the FERC can deal with it or that we can deal with it through modest changes in the NGPA.

The Reagan administration's proposal goes far beyond the modest changes which appear to be necessary. Although a "market out" provision may be all that is necessary, the administration goes far beyond that to allow immediate decontrol through a "fruit basket upset" of contract renegotiation. It claims that these renegotiations will reduce prices. I doubt that. The NGPA already allows prices to fall, because it sets ceilings not floors. If there are institutional problems which artificially keep prices at the ceilings, then they can be removed, either by the FERC or by Congress.

If the administration's concern is to reduce prices, it certainly will support the removal of such barriers. Perhaps it can convince its appointees at the FERC that they already have authority to deal with the problem.

I have to confess some skepticism here, because there is no doubt in my mind that the primary purpose of the administration's bill is to decontrol old gas. The rest is largely window dressing. It would never have been proposed without decontrol. The problem is high prices, not controls on old gas, so the administration's bill should not be the focus of our deliberations. We must look to other alternatives.

The Chairman. Thank you, Senator Bumpers.

Senator Wallop.

STATEMENT OF HON. MALCOLM WALLOP, A U.S. SENATOR FROM THE STATE OF WYOMING

Senator Wallop. Thank you, Mr. Chairman.

I join in welcoming the Secretary here, and the next time you have a hearing like this you had just as well come an hour late while we proceed with hearing ourselves.

It is difficult for me to conceive of a metaphor that will hold gas right now, but I have a full statement which I would hope would be put in the record at this place.

The Chairman. Without objection, it is ordered.

[The prepared statement of Senator Wallop follows:]

Statement of Hon. Malcolm Wallop, a U.S. Senator From the State of Wyoming

Mr. Chairman, I welcome the beginning of these hearings on possible natural gas legislation. The problems which we are presently experiencing in the natural gas area where not entirely unexpected, and while all of the distortions could not have been anticipated, it is clear that when you create a regulatory scheme that provides for 28 pricing categories with prices differing as much as $10.00 per mfc, you are going to have problems. The simple fact that prices continued to rise despite the presence of a "gas bubble" or over-supply of gas dramatically portrays the magnitude of the natural gas problem. Indeed, much as a recent article in Newsweek stated, "It all boils down to a classic case of bad regulation."

The Administration, through the able leadership of Secretary Hodel, has offered natural gas legislation which attempts to sort out the many conflicting interests in the natural gas area and provide a balanced approach which protects the consumer, while at the same time providing a transition to the certain decontrol of natural gas. It is not an enviable task, but the bottom line is that we must provide the American people with a mechanism that will assure a reliable supply of natural gas at reasonable prices. The NGPA was a bad compromise, and like most political compromises, efficiency was the first to be sacrificed. I am sure that during the course of these hearings, we will discover that it is much harder to untangle the effects of complicated regulation than it is to create it.

It is hard to dispute the goals of the Administration's natural gas proposal. My hat goes off to the new Secretary of Energy, Secretary Hodel, who I think has done an incredible job of recognizing the problems and attempting to deal with them. However, despite his good efforts, some very significant questions remain, and I hope this forum will serve that purpose.

The initial question is whether the Administration's proposal, as written, will achieve the goals which the Administration has set out. That question must be answered by examining the impact of the proposed gas cap as well as the pipeline pass-through provisions. We do no one a service by passing legislation which removes the incentives for producers to drill for new supplies of natural gas. The lack of gas at any price cannot heat a home or employ workers whose jobs depend on a reliable source of energy. On the other hand, we clearly cannot afford the market distortions that have resulted under NGPA.

More specifically, I would hope the Secretary would address many of the following points during the course of his appearance here today. Does the operation of the pass-through provision limit the ability of pipelines which have relatively inexpensive supplies of gas to renegotiate old contracts or enter into new contracts? Put another way, are those pipelines whose average cost of gas is significantly higher than other pipelines given more flexibility because of the pass through limitation to negotiate new, or renegotiate old contracts? Do we, with this legislation, hamper the ability of pipelines which have secured less expensive gas from their producers to continue to negotiate with them for a reliable source of gas at a reasonable cost?

Additional concerns have been raised with respect to the gas cap. It may well be that additional clarification is all that is needed in this area, but I do share a concern that I am sure will be explored during the course of this hearing that the gas cap may put an artificial constraint on this nation's need to continue to explore for new supplies of natural gas for that same consumers future needs.

I realize, as I am sure all of my colleagues do, that there are very differing views on how we should deal with the natural gas issue, but let me make a few concluding points which I think should be made. It must be our intention to deal with natural gas in a realistic manner—this does not mean that we keep prices down in the name of the consumer, if by that action we take away the incentives to explore for new supplies of natural gas. But at the same time we must address the present situation that has seen prices rise in complete contradiction of the law of supply and demand. It must be our objective to assure the American public of reliable supplies of natural gas at a reasonable price which is not set by the Congress, but by prudent business sense under conditions set by the market place.

In conclusion, I would note that over the past several months, producers and pipelines have begun to renegotiate their supply contracts to bring those contracts more in line with current economic conditions. Let me urge them to continue those renegotiation efforts. As you well know, the natural gas debate is not going to end today, and those renegotiations continue to be the best thing we can do for the consumer and the natural gas industry.

Senator WALLOP. Let me say to my friend from Ohio. That if you or others try to solve the problem that the country has solely from the standpoint of the consumer, you will end up creating the demise of both the producer and the consumer of natural gas. That is where we were before.

Newsweek a few weeks ago called this Natural Gas Policy Act a "classic case of bad regulation." Senator Bumpers was just talking about it was difficult for him to see anything because the bill sets a ceiling, and every time, my friend, you set a ceiling by regulation, you create the floor that is exactly the same level. It is not possible to do otherwise.

And that is where we are now. We have created, in this Congress, with that Natural Gas Policy Act the mess that is there now, and we must get out of it, both from the standpoint of the consumer, and his future supplier because it is of no consequence for the consumer to protect his price now and deny him gas at any price somewhere down the road.

And I just suggest to you, as the Senator says he has a long memory, but it is very selective, because just 2 years ago, that same Senator was saying that if we decontrolled oil, the price of gasoline would be $2 a gallon at the pumps now.

The fact of it all is there is a dimension of balance that has been mentioned by several people here. We have to create the situation in which people can afford yet to look for it, and to create the ongoing supplies.

We have to create a situation where that consumer not only has reliability in the price that he pays, but reliability in the future of it, because those things are inexplicably wrapped together.

I would hope that we would take the advice, Senator Warner, and that we work together, both in the interest of the consumer and the producer for long-term stability in this country's energy policy; and we are not going to get it by traveling down the road that we once followed.

Senator **Metzenbaum**. Mr. Chairman, I don't normally respond to comments like these. Since two of my friends on the other side seem to be suggesting that I intend to be uncooperative, let me advise both of them that I had already offered to work together on a bipartisan basis with one of the members on their side, and I certainly would be delighted to work together with them.

But I want to respond further to my friend from Wyoming. Consumers are the American people. Consumers are not different from the American people. They include small business people, farmers, the citizens of Wyoming, as well as those of Ohio.

I say to you that if you think the consumer is somebody strange out there and not part of your constituency, or Senator Warner's or anybody else, then I have to explain to you, that is not the way it is.

I voted against, and worked to defeat the Natural Gas Policy Act, as you well know. I think it was bad legislation then. I do not think it is as bad as the proposal the administration has put before this committee. I would be glad to work with you on a bipartisan approach to solve the problem.

Senator **Warner**. We accept that challenge.

Senator **Wallop**. I would say, Senator, that I voted against it too but for quite a different reason, than I think you did.

The **Chairman**. Senator Murkowski.

STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM THE STATE OF ALASKA

Senator **Murkowski**. Thank you, Mr. Chairman.

I would like to go back to the regular rhetoric. I would like to commend the President, and you, Mr. Secretary, for proposing the legislation which is intended to return natural gas to the free market through a phased and orderly transition.

I think most of us were pleasantly surprised when we saw the President's proposal for the first time. Clearly, the bill attempts to address the many problems which exist from the wellhead to the burnertip in natural gas markets today.

I perceive some problems with the legislation as it is currently drafted, but I believe it does create a framework within which we can begin to address the problems and distortions which have plagued natural gas consumers in recent years.

Mr. Chairman, during the course of these hearings, I suspect we are going to hear from a number of consumer advocates who will argue that massive reregulation is the only way to protect the natural gas consumer from spiraling prices and distorted and unfair markets, and that has already begun with the conversation among my colleagues.

But as is clearly shown by the history of the Federal Government's involvement in natural gas wellhead price regulation, that assertion is utter nonsense.

Instead, the recent increases in consumer prices have been the direct result of market distortions created directly by Government regulation.

Natural gas has been subject to wellhead price controls since 1954. In 1978, Congress attempted to correct the chronic and serious problems brought about by Federal regulation by enacting the Natural Gas Policy Act, and the NGPA was based on certain well-meaning assumptions about the nature of natural gas and its market, the anticipated prices of competing fuels, the general and prevailing economic conditions in our country, and general assumptions about the manner in which the industry and consumers would behave under certain circumstances.

But Congress was incorrect in many ways in its assumptions; and, as a result, serious market distortions were generated. Congress mistakes are best illustrated by the fact that the gas prices are rising today even though we have a near-term excess deliverability.

I am a great believer in the free market system, and as a banker before coming to the U.S. Senate 2 years ago, I clearly observed the operation of market forces and found them to be nearly always preferable to Government intervention.

When the free market can work, we must allow it to work. However, after studying the natural gas market, I must temper my deeply rooted free market inclinations by noting that the unconstrained market may not necessarily be the best in every situation. One situation, Mr. Secretary, I would appreciate you addressing this morning, involves possible exceptions to the free market rule.

For instance, are there instances where the structure of natural gas and market might not lend itself fully to free market interaction?

For example, if a powerplant is built over a remote gas field, that particular instance comes to mind. If the powerplant is not linked to any gas or alternative energy distribution system, can competitive prices operate in that kind of a climate?

I know of several examples of this situation in both the Southwest United States and in my own State of Alaska; and I see no provision in this legislation to deal with this kind of a situation.

I would also hope, Mr. Secretary, that you will address yourself to the economic and market assumptions which are the foundation of this legislative proposal.

For instance, what assumptions about the price of oil, the extent of economic opportunity and recovery, and other relevant factors that have guided the development and drafting of this legislation?

Another area, Mr. Secretary, that I have concern about are the realities which will manifest themselves as a result of this legislation in the years ahead.

Precisely, what can we expect the price of natural gas and competing fuels to be in 1986 under this proposal? Will prices increase substantially, and will there be political pressure at that time to reopen this issue in 1986 or shortly thereafter?

And I realize these are difficult projections to make, but I think they are appropriate. I do not willingly place the Congress in a position of having to repeat this exercise in a few years. I am sure my colleagues will share that.

To summarize, I believe that the Federal regulation of natural gas at the wellhead has been unfruitful at this time. As a recent Washington Post editorial aptly noted, price controls create shortages in a rising market, and distortions and inequities in a falling market.

We must move toward decontrol where the market can work, while making special and careful provisions in those instances where the market cannot work.

We cannot continue to waste private and public resources by trying to repeal the law of supply and demand through regulation.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Thank you, Mr. Chairman.

I have a rather lengthy opening statement, but I will do my best to condense it.

Mr. Chairman, I look forward to these hearings as perhaps the most important this committee will hold this year. Some legislation must be reported out of the committee to address the serious problems of the Natural Gas Policy Act of 1978.

The question for us is what should the legislation look like. The administration has started the ball rolling, and I think they have made a useful contribution.

Most important is the broader focus on natural gas pipelines, not merely wellhead prices. Competition in the natural gas transportation industry is now lacking. This is one reason that prices for natural gas can vary widely across the country and even within regions or States.

Another reason for the wide variation in prices is the Natural Gas Policy Act, which keeps market forces from distributing gas supplies efficiently.

In New Jersey, I think we have a good example. We are served by two major natural gas pipelines. The bulk of our gas—55 percent—comes via Transco, the pipeline with the highest average cost of all interstate pipeline companies.

Transco has by far the highest volume of all interstate pipelines of high cost 107 gas. This means that New Jersey customers, homeowners and industry, pay among the highest rates in the country. Only New England, further from the producing areas, pays more for its gas than New Jersey.

New England homeowners paid an average of $7.38 per million Btu's in the year ending September 30, 1982.

The Mid-Atlantic States paid $5.64; North Central States, including Missouri and Kansas, paid only $4.39.

Homeowners in the producing States paid about the same—$4.28.

I believe, Mr. Chairman, that competition among pipelines can go a long way toward eliminating the price disparity which places industry and commerce in New Jersey in the Northeast in competitive disadvantage with other parts of the country.

The administration proposes to remove price controls from so-called old gas. While this might remove the noncost based geographical price disparities that I just mentioned, it would also impose a hardship on some homeowners, especially low-income homeowners and renters.

The administration's consumer protection provisions are, in my judgment, insufficient. What people need is not more regulation, like the complex gas cap; what people need is assistance in adjusting to the realities of the new natural gas market.

If the administration convinces Congress to decontrol old gas, I believe that a tax must be placed on old gas. The proceeds would be specifically devoted to low-income energy assistance and conservation measures in depressed, urban neighborhoods.

Mr. Chairman, I will be interested in the opinions of our witnesses as to the cause of the regional price disparities, after transportation differences are accounted for; and I will be interested in ways that they propose to resolve those disparities, and, finally, I will be interested in assisting those people least able to cope with turbulence of this natural gas market.

Thank you.

The CHAIRMAN. Mr. Melcher.

STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator MELCHER. Mr. Chairman, I am only going to make a couple of comments and not take up the time of the committee so we can get to the witness. If the criteria for a good bill is one where no one of the various groups is pleased by it, then maybe this would qualify, but it is fair to say that consumers are very apprehensive about this bill.

Utility gas companies are very apprehensive about it. A lot of pipeliners are apprehensive about it. Industrial users, that segment of the consumer part of the spectrum, are very apprehensive about it. Almost no one is pleased, except owners of old gas, and for the reason that they are pleased, others are very apprehensive.

Perhaps we are going to have a very vigorous discussion of various concepts of deregulation of the gas, but end up still plodding along with the same law we do have, which is overburdened by redtape, but it does not seem to be solved by this proposal before us.

Thank you, Mr. Chairman.

Mr. CHAIRMAN. Thank you, Senator Melcher.

Secretary Hodel, you have been waiting very patiently. I am sure you have found yourself very much enlightened by the comments that have already been made.

Having heard the comments of various members of the committee, I am sure you are now ready to revise your statement.

We do welcome you before the committee today, Mr. Secretary.

As I said in my opening comments, I want to commend you and the administration for having come forward with a proposal that is innovative, balanced, and as some would say, the point of departure—I would say the point of beginning—for the discussion with respect to what we might or might not do.

Mr. Secretary, your entire statement will be placed in the record. You may proceed in whichever manner you desire.

STATEMENT OF HON. DONALD PAUL HODEL, SECRETARY OF ENERGY

Secretary HODEL. Thank you, Mr. Chairman.

I will try to summarize some of the points in that opening statement and then be available for questions.

I want to thank you, Mr. Chairman, and the members of the committee, for your welcoming remarks—in some cases encouraging, and in some cases cautionary notes.

But I do welcome this opportunity to come before this committee and commence this discussion of what is clearly a very important and significant issue to the American people, to our economy, and to our entire energy system, because of the importance natural gas plays as part of the energy supply of this country.

I believe the public interest will be served by these hearings, and I need to say again—and I will probably say it again and again in this process—we have come forward with a proposal, but my comments in defense of that proposal should not be read in any way that we are not agreeable to attempting to improve what we have brought forward.

From all of the comments that I have heard here today, I think we share a common goal—and that is to provide an adequate supply of natural gas at a reasonable price for the American consumer.

What we have attempted to bring forward here today is a comprehensive and balanced approach that will move us toward the free market which, in the long run, I believe, is the only way in which we can provide long-range assurance to the American consumer of an adequate supply at a reasonable price.

Senator Murkowski commented on our effort to move toward a free market through a "phased and orderly transition." I think those are excellent words to describe what we have attempted to do.

And if we are, in fact, beginning a second 30 year's war, one comforting comment I would like to make from my personal point of view, is that the average tenure of a Secretary of Energy is about 1¾ years, and I wish the rest of you a great deal of good fortune. [Laughter.]

The history of this natural gas market has been recounted by a number of you more expertly than I could do, and certainly we are aware that by the middle of the seventies—in the winter of 1976-77 we confronted shortages in this country. We had a dual market system in which the interstate market had prices at 70 cents, and the intrastate market had $1.20 prices. And as a result, the interstate market was suffering from severe shortages during a severe winter. This Congress clearly recognized at that time that, if we must choose between a supply problem and a price problem, we can live with price problems—there are adjustments that can be made; there are assistance programs for people who have difficulty paying those prices. But, if the gas is simply not available, industries shut down, schools and hospitals shut down, and homes are in jeopardy.

Cities in this country were faced with great risk of problems at that time. The Congress reacted, and the Natural Gas Policy Act, in my estimation, as was said by several, was the best alternative that could come forth from the Congress at that time. It achieved part of its objective which was to increase the supply of natural gas, but it also provided a system of very rigid price controls. Those price controls, combined with the contracts that people have chosen to enter into under the assumptions created in that crisis in the middle seventies, have led to the current situation.

We have today the anomalous situation, which I think several excellent editorials have commented on, of rising prices during a period of surplus supply.

As every first year economics student can tell you, what happens when you have more supply than demand, is that the price goes down. But, that is not true in a controlled market; and it clearly has not been true with this particular natural gas market.

The work of this market is evidenced in this chart. On the left-hand side of the chart are the pre-Natural Gas Policy Act prices.

The intrastate average price, as I indicated, was substantially above the interstate average. This was the situation in which the Congress found itself as it attempted to deal with the problem.

We note that, on the portion of the chart dealing with the period following the passage of the NGPA, only some of the prices allowed for the numerous various categories of gas are shown. You notice that some of those gas prices are between $10 and $11. Others are at less than 60 cents—we are in the 60-cent range, a vast disparity; and the red line which moves from approximately a $1 average up to the $2, $2.50 range, as of the beginning of 1983, is the composite average of those various prices reflecting the different volumes and price levels that those prices indicate.

And, of course, it is the angle of that price line that has contributed partly to the complications and concern over the increased prices in the consumer fields today.

Clearly, the purchase price adjustment process which permits pipelines to pass the cost they incur for increased gas prices directly on to the consumer, without any significant delay, has been a significant part of the problem.

Another part of the process has been the mix. As increased amounts of new gas are brought in at high prices, even though the percentage is not great, the price differential is so great it tends to increase the price at a more rapid rate than was anticipated under the Natural Gas Policy Act. One of the contributing factors to that, which has been touched on in some of the comments earlier, is the effect of these contract clauses, particularly the take-or-pay contract clauses.

The take-or-pay contract clauses were entered into by pipelines under the impression created by a series of comments and opinions expressed in the middle seventies that we were running out of natural gas. Pipelines, in an effort to secure an assured supply of gas, agreed with producers of newer, higher cost supplies to take very high percentages of the contracted amount.

If they did not take them, pipelines agreed they would pay for them in any event.

Now, the problem is, if they have to pay for it but don't take it, they are not permitted to pass the cost on to the consumer; and the carrying charges are detrimental to the economics for the pipeline.

And, so there is a great incentive for a pipeline to take at a high level, from the high cost contract, because that permits the pipeline to pass that cost on directly and immediately.

The Federal Energy Regulatory Commission [FERC], which has been criticized for its handling of these provisions, is entitled to review those contract passthroughs, after the fact, for fraud or abuse.

Now, they have not seen fit to redefine the word, "abuse," to mean "prudent" or "just and reasonable," which, I think, is a reasonable position for them to take.

Congress provided the word "abuse." I suggest it may be appropriate for a regulatory commission to be somewhat careful about how it decides to expand the interpretation of its responsibilities by definition in ways that clearly never were intended when the act was passed.

But the effect of these take-or-pay contracts, therefore, has been increasingly to pass through high-cost gas to the consumer at the time when we know there are shut-in, low-cost wells out there where producers would like to be supplying some of that gas, and they simply cannot find a way to the market.

One of the serious problems this creates is that it is not just the low-income person who is suffering, but the middle-income American who can afford to pay the price but who resents increased prices. The American consumer truly is outraged when he believes he is being "ripped off" by a system which has low-cost gas retained in the ground, while high-cost gas is passed through to him at higher prices.

This helps create the supercharged atmosphere we find today.

The next chart I have, that is before the committee members as the top chart in the set of charts I provided you, is the natural gas market schematic.

On the lefthand side of that chart, we have the wellhead price controlled by the Natural Gas Policy Act [NGPA].

Again, it is schematic—we have old gas, new gas, deep and tight sand gas, imports, LNG, and all others. We don't have the 28 categories of gas prices and we don't have all the subsidiaries or subsets of those 28 prices.

But, taking a look at that chart, there are some 200,000 gas wells in this country and over 12,000 producers. We have approximately 17 percent of the market being supplied by the 4 largest producers; 42 percent of the gas supply is supplied by the 16 largest producers; and I suggest they are approximately in the same ratios that, I am advised, apply to reserves.

What that tells us is we have a market which, I would say, in view of the comments we often have heard in discussions to date, is really much more potentially competitive than people sometimes anticipate. There is a much broader range of production out there, in more significant amounts, than you might think. The concentration is not great.

On the consumption end of this scale, as we look at the end use price controlled by the Public Utilities Commissions, approximately 38 percent of gas is consumed by industry; 26 percent by residential users; and the rest are powerplants, chemical feed stocks, and the like.

I think, if we look at this chart, we have an average wellhead price in the country today on this schematic of approximately $2.75. That price may or may not be exactly right; the figure probably should be $2.75 to $3 or $3.25, as a rough average.

If you take the transmission costs of the pipelines, on average—that is about an additional $1 cost, which would mean the average city gate price in this schematic is $3.75; and that, in turn, is the price at which the pipelines sell to the distributing companies.

We have a three-part market. The transmission costs are governed by FERC regulation, but not those parts that deal with the cost of the natural gas, because, as I have indicated, the price of gas passes through and only can be reviewed in retrospect.

The end use price of gas is controlled by State public utility commissions.

The next chart which we have, and which you have before you—the last chart in the packet—indicates the multiple gas pipelines that exist in this country, and also indicates I think quite effectively, there is a remarkable amount of interconnection and multiple service capability in multiple markets.

This, again, is an important opportunity for the kind of competition among pipelines that was mentioned by Senator Bradley in his remarks.

Now, I have been to numerous meetings, Mr. Chairman, with consumer groups, producers, pipelines, users, senior citizens groups, and combinations of all of the above in various permutations. My staff has met with numerous representatives and spokesmen for those groups.

I believe you said it correctly, Mr. Chairman, when you stated "There is no consensus in the industry." I think we can extend that further. It is clear there is no consensus on this issue at this time.

I think it is in that atmosphere, and it is with that understanding, that the administration came forward with a bill. Some reference was made to some of the prior approaches which were considered by the administration, and I would point out the administration did not come forward with proposals which were not broadly enough based to have the potential of achieving a consensus.

Above all, reference also has been made to the need for a bipartisan approach. It is clear, if we are to achieve a bill through both Houses of this Congress, we must have a bill which can achieve bipartisan support. Clearly, that is the President's desire; it is mine, and I know it has to be that of the members of this committee, and I look forward to helping you in that effort.

Three basic principles are essential, it seems to us, to any bill that comes forward in this area. First, there must be freedom to negotiate. We must move toward the free market and achieve a free market for that portion of our chart of the natural gas market which is represented by the gas supply—the lefthand column on that chart.

We need freedom to negotiate.

Second, we need to eliminate the disincentives for low-cost gas to reach the market. Those disincentives don't just cost the consumers more money; they create a real perception problem on the part of the American consumer with regard to the fact that they are being ripped off.

Third, we need to have a consumer protection element so that we are not asking the American consumer, during this period of transition, to assume the risk, that we would have a workable market.

I may say, up to about a month ago, Mr. Chairman, as we considered our effort to find a way to move toward a free market, and to try to find a way to deal with those contract clauses that clearly are not operating to the benefit of the market or the consumer or anybody else, I was not very optimistic. I was concerned about two things we would face. First, with only those two provisions, we would be asking the consumer to take the risk; and second, I did not see any incentive for the pipelines to sit down and to negotiate contracts for the lower cost gas.

My concern centered on the fact that, when two parties—the producer and the pipeline—sit down to negotiate, both of them know that whatever price they agree to, provided it is not fraudulent or abusive, can be passed through to the consumer and only can be rejected under subsequent review by FERC if it is found to be fraudulent or abusive.

The pipeline is not put in the position of negotiating the least cost contract. It makes it easier for the producer to be tough in those negotiations, and to hope that 50 cents or $1 extra may be left on the table. Nobody can prove that has happened; but if human nature works as I think it works, it is a reasonable expectation. It seemed to me, therefore, when we finally focused on the need for consumer guarantee, the consumer would not run the risk, and we had achieved the final keystone or linchpin for this proposal. I view that as the linchpin of our proposal, and not the effort to decontrol old gas. That seems to be an important effort for achieving a free market which will work for the benefit of the consumer; but the consumer protection provision is the one which, I think, has brought us as far forward as we are today.

We considered a number of ways to try to protect the consumer, and the first thing that we talked about was, what about a freeze?

We do not believe it serves America, or American consumers, by falsely sending signals to them that a commodity is properly priced at some level by arbitrary fiat. This encourages increased consumption, above what the market can bear, and raises the risk that investments will not be made in further supplies. We know that a frozen price has had the effect in the past of ultimately resulting in a loss of supply in this country, and that is not tolerable.

So, we rather promptly disposed of that.

We considered also a windfall profits tax. I was interested, in my discussions with representatives of consumer groups, to find that they did not support a windfall profits tax for a couple of very interesting reasons. First of all, they did not believe the Federal Government could be trusted to collect the money and pass it on to the people to whom it originally was intended. I think it is a great step forward for America for them to recognize that the Federal Government Treasury cannot be trusted, necessarily, to do that once it has collected the money.

Once it is in the hands of the Treasury, there are many people who then have designs on the funds.

There is a second serious problem with the windfall profits tax. It really needs to be looked at, because in the end—and consumer groups have said to me now they recognize this—the consumer pays. Ultimately, the consumer pays the windfall profits tax.

Third, and in this case, very importantly, if you pass a windfall profits tax, how does it operate? Looking at this schematic, the price goes up—under this assumption. The price goes up, creating a windfall profit. It passes through the pipeline. It is felt and paid by the consumer.

Now, the problem is, we have consumers who don't like to pay those increased prices and should not have to pay those increased prices if they are above what the market should dictate. But, under that approach, he has to pay them.

In the meantime, then, the Government goes out, collects the tax, manipulates the funds, massages it to some extent, and eventually, hopefully, some of it finds its way to the intended recipients.

But, the bulk of the consumers already have paid the price which gave rise to the windfall profits tax. It does not protect consumers. It punishes or penalizes those who collect a windfall. It may enhance the Treasury revenues, but it does not protect the consumer.

The fourth item that we considered was a nifty contract revision proposal. We basically had a great idea that we would write a contract provision which would be imposed on all contracts requiring a rebate from the producer, through the pipeline, to the distributing companies for the benefit of consumers who paid more money than they should have. When we finally took a good look at that, we realized I would probably need four more Forrestal Buildings full of regulators just to try to enforce that. It clearly was not the kind of provision that had any real chance of doing what needed to be done. It was at that point, in an effort to provide that consumer guarantee, we came up with the passthrough limitation, which we think is clearly a viable approach, and one which provides an incentive to those pipelines to negotiate in the new contracts.

Then the question was, well, what about the existing contracts?

We decided we had to have some kind of gas cap. Now, today, if nothing is done by Congress, the Natural Gas Policy Act [NGPA] will continue to operate, and it will provide certain gas price limitations; so we said that is clearly one price that would be imposed on those contracts—that is the way the law is today.

Then, we said, the lower price, it is negotiated in the market—after all, what we are seeking is market price—ought to be the one applied in those contracts.

And so, we apply to those contracts either the Natural Gas Policy Act or a lower negotiated price. That provision only can operate in one direction; it only can cause prices to go down.

If, as has been suggested, some of the new contracts are at prices above the NGPA level, they cannot have the effect of driving the price up because the gas cap only operates if it is below the NGPA level.

I am concerned about one element of this whole process. This is an extremely complex market. It has many, many facets.

You and I are receiving all kinds of advice from very, very interested parties throughout this whole process.

In a complex issue of this type, where there is a great deal of public attention, I am concerned that the easiest way to try to deal with it is with some kind of quick fix, or meat-ax type of approach.

In fact, I am acutely aware of that because I can assure you, from the time I became Secretary early in November until the time we came forward with this proposal, there were several times that type of approach began to sound like an awfully good idea to me also, Mr. Chairman.

But I don't believe that is in the best interest of America, and I don't believe it is in the best interest of our consumers.

One thing that I think this committee and those who comment on this problem must be aware of, and need in fairness to the American people to comment on, is that in this last year, only about one-half of the price increases that have been felt by the consumer are represented by the wellhead price.

What you need to remind yourselves is approximately one-half of the increased prices have come through the other costs incurred by transmission systems, and by the end-use cost incurred by the distribution system.

Those points need to be kept in mind as we talk about the price savings that we see in this bill. If we see a 10- to 30-cent drop, as our analysis would indicate, from the price of gas under our proposal, we are talking about a 3- to 10-percent drop in the wellhead price of gas, but that is only about half of the total cost increases that have been seen by the consumer.

At the present time, Mr. Chairman, as far as I can tell, the proposal we have brought forward places a burden on pipelines—and I recognize they are not delighted with that at all—to negotiate responsibly for the consumer to find that lowest cost price. This is the only system that I presently am aware of that holds any real hope of getting the low-cost gas to the market.

One of the issues that we have not resolved, unfortunately, by any method I am aware of, short of trying this system, is how much old low-cost gas really exists. We know some wells are shut in. We know there has been a tremendous disincentive for money to be spent on upgrading old wells or developing existing fields, which are low-cost fields. To put your money in drilling a well, even though it is a relatively inexpensive well, where you cannot charge more than 60 cents or $1 or $1.25 for the gas, has not been an attractive prospect.

We do not know what the supply prospects are. I may say, in our analysis of this proposal, we assume there would not be a significant change in the amount of old low-cost gas that becomes available as a result of this approach.

Probably, that is not a valid assumption, but if it is wrong, the only thing it can do is to have a beneficial effect on our numbers in terms of what it means to the consumer.

So, the question is: How do we get to a system which generates additional supplies of lower cost gas? Obviously, we believe we have to go to a free market negotiating process which provides an incentive for that low-cost gas to go first. I have talked about the pipeline pass-through provision and how it operates.

I also have talked about the gas-cap, and I know there are concerns, as Senator Johnston indicated about how those two provisions will operate.

We also have a couple of other important provisions, Mr. Chairman, in this bill. One is that we provide what I call mandatory contract carriage, so that a producer who has a supply of gas which is not contracted for by a pipeline has the opportunity to go forward and attempt to find a market and transport it through that pipeline to the market.

And, second, we do provide contract relief by permitting pipelines to reduce their take, under the take-or-pay contracts, to a 70-percent level.

These provisions ought to have the effect of reducing the price to the consumer. The further effect of repeal of portions of the Fuel Use Act and the repeal of the incremental pricing provision of the NGPA further should assist the consumer price. As it has been discussed today, the effect of those laws has been to reduce the gas carried in the pipeline; it has increased the per unit cost to the balance of the consumers in that pipeline and certainly not worked to the benefit of the consumer.

One of the questions raised, and I am sure it will come up again, is with regard to our willingness and ability to deal with contracts.

I will be happy to discuss that with the committee. I may say it was the first question I raised when we started talking about rewriting or abrogating contracts. Why and how would we do that? I am pleased to say that has been the first question I have encountered in almost every discussion with people throughout the process when we talked about the contracts.

I am satisfied, if we desire to resolve the market problems and do something about natural gas in this country, we will have to deal with the contract clauses; we will have to do something about those contracts. Further, I am convinced we have the authority under the Constitution to do so.

I need to emphasize again that we are not tied to these words, but I think the principles are sound, and will have to be a part of any proposal that realistically seeks to solve both the short and the long-term problems.

I am convinced, if passed as it is, this proposal will work. Obviously, the debate that ensues will test whether or not it is adequately balanced.

So far, I am encouraged by the kinds of responses which have indicated it is adequately balanced, No one sector wholeheartedly endorses this entire proposal. We worked with 18 principles, and, time after time, I heard people say to me: "We like 14 of the principles; we don't know about two of them; and we don't like two of them."

The good news is that is a pretty good ratio. The bad news is that nobody agreed on what the two were they didn't like.

I think this bill would provide an adequate supply at a reasonable price. I believe it does protect the consumer and I know we will have a chance to discuss that fully.

I think an important feature is that Congress, under our proposal, during the period of transition, will have every opportunity for continuing review. There need be no undue risk that the consumer will be hit with price increases which are not appropriate because somehow the market didn't work as was anticipated.

Thank you, Mr. Chairman. I will be happy to try to answer questions.

[The prepared statement of Secretary Hodel follows:]

Statement of

DONALD PAUL HODEL

SECRETARY OF ENERGY

Thank you, Mr. Chairman. I welcome the opportunity to appear before the Committee this morning on behalf of the Administration to support the Natural Gas Consumer Regulatory Reform Amendments of 1983.

We are proposing this legislation to assure American consumers an adequate supply of natural gas at a reasonable price. We believe that our proposal will achieve this result, and we look forward to beginning this legislative dialogue.

Let me begin by briefly discussing the importance of natural gas to our economy and outlining the rather complicated history of price regulation that has created today's situation.

THE NATURAL GAS MARKET

Natural gas is a major source of energy in the American market, providing close to one-third of all domestically produced energy since the early 1960's. About 19 trillion cubic feet of natural gas are produced in this country each year. There are thousands of natural gas producers operating some 200,000 producing gas wells. The greatest demand for natural gas, about 38 percent of the U.S. total, is in the industrial sector, followed by about 26 percent in the residential sector. About 56 percent of all residences heat with gas, and 65 percent use gas for some purpose.

The ease with which natural gas can be used and its clean environmental properties have made it a very attractive fuel. In addition, natural gas and petroleum products are interchangeable over a number of end uses, particularly in the industrial sector. Of more than 6,500 large boilers in 1979, about 45 percent were capable of switching easily from natural gas to a competing fuel.

Given that natural gas is such a flexible and useful energy source, one would expect substantial price competition to exist among gas, oil, and coal over a variety of end uses. However, natural gas is limited in its ability to compete because it is now the only fuel that is regulated at the point of production. Unlike the situation in the coal and oil markets, where prices and production can respond fairly rapidly to upward or downward pressures of the free market, natural gas prices are subject to rigid price controls to the point of being nearly unresponsive to market forces.

Gas prices to consumers have continued to increase despite the fact that plentiful supplies of less expensive gas are available. The evidence clearly shows this to be the result of both the regulatory environment in which producers and pipelines made their contract decisions and the set of exceptionally complex regulations that currently govern the gas market. The result is extreme market distortion, where neither producers nor pipelines can respond readily to competition, where incentives to develop low-cost resources are lacking, and where consumers are paying more than they might in a free market. The Administration shares with Congress both a deep concern about -- and a commitment to resolving -- this situation.

HISTORY OF NATURAL GAS REGULATION

It is important to understand the pattern of regulatory actions and adjustments that have led us to this point.

Although the interstate natural gas market has been regulated since 1938, it was not until 1954, with the Supreme Court decision in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), that price regulation was extended to the wellhead. Following that decision, and during most of the 1960's, wellhead prices set by the Federal Power Commission were at or above market-clearing levels and, therefore, had little effect on the market. With the economic expansion and inflation of the late 1960's, however, demand for gas at what turned out to be low, price-controlled levels in the interstate market increased sharply. This led to supply problems in the interstate market as producers were unwilling to invest in more costly new production and to sell at the lower federally controlled prices when they could receive higher prices for their gas in the unregulated intrastate markets. Because intrastate prices were free to rise to levels where supply and demand came into balance, prices in this market grew to be substantially above the FPC's interstate ceilings.

The supply-demand imbalance in the interstate gas market was dramatic. Reserves dedicated to interstate commerce dropped sharply. Limited curtailments began to be felt in the early 1970's. With the 1973-74 oil embargo, the price of oil quadrupled; and the price gap between interstate and intrastate gas markets widened rapidly. Curtailments became more serious. In the winter of 1976-77, federally controlled prices at the wellhead averaged about 70 cents per thousand cubic feet while the intrastate market price for gas averaged about $1.20 per thousand cubic feet.

It was during the exceptionally cold winter of 1976-77 that conditions in the gas market reached crisis levels. Many interstate pipelines fell far short of meeting consumer demand. They simply were unable to purchase the gas they needed. Service to homes was threatened. Entire metropolitan areas were faced with loss of their gas supplies. Congress rushed emergency legislation into law, allowing for allocation if necessary. To many, it appeared that the country nearly had exhausted its natural gas supplies. In fact, it was the artificial regulatory environment, with low prices that encouraged demand while suppressing production, that gave such a false picture of the market's potential.

It was in this environment that additional regulatory adjustments to the market seemed necessary and led to the enactment of the Natural Gas Policy Act of 1978. The NGPA was therefore designed to address the need to encourage exploration and development of new gas supplies for interstate use. It was understood that, to accomplish this objective, the prices of interstate gas would have to increase.

Although interstate supplies increased after 1978, the NGPA did not work as planned. The NGPA attempted to establish a market for gas that encouraged new production on the one hand while keeping consumer prices low on the other. To do this, it created 28 different pricing categories, ranging from categories with very large incentives for high-cost new supplies, such as deep gas, to very stringent controls on lower cost supplies. Five years' experience under this law has proved that it is not working. Some producers cannot sell their gas, even though it is much cheaper than supplies currently being bought. Consumers are paying higher prices for gas, as though additional gas supplies were not available. Pipelines are finding themselves bound by onerous contract terms they signed based on a belief in scarcity that the regulations fostered. These contracts have prices tied to artificial regulatory ceilings that keep prices rising, and they also have high take-or-pay provisions that encourage production of the most expensive supplies first while production of less costly supplies is reduced. These situations could not exist in a free market.

If the natural gas market were not regulated and were allowed to operate the same way that all other major energy markets operate, increased supplies of gas, coupled with stagnant or declining demand for gas, would drive the price of gas down. This is the present situation in the gas market -- except for the NGPA price controls that are preventing the market from working.

Competitiveness of the Gas Market

The competitive nature of the gas market would solve these problems if it were allowed to operate. Many have argued, however, that the gas market is composed of a small number of integrated companies and, as such, is not competitive. Our analysis demonstrates that this is simply not true. In 1977, the largest four gas producers accounted for only 17 percent of U.S. production, the largest 16 producers accounted for 42 percent. They controlled equivalent percentages of U.S. reserves. All told, there are more than 12,000 gas producers today and many more would be available to go into the business if the opportunities presented themselves.

The Administration's proposal would take advantage of this multiplicity of competitive forces to develop the less costly gas supplies, to the consumer's advantage.

In summary, the situation in today's gas market is similar to that in the oil market 2 years ago. The deregulation of oil prices helped cause a decline in oil prices, which continues even today. Abundant supplies and competitive demand caused prices to fall, and consumers are reaping the benefits.

PRINCIPLES OF THE ADMINISTRATION PROPOSAL

The Administration's goal regarding natural gas is to provide an adequate supply of this critical energy resource to the consumer at reasonable prices. As we explored all facets of this complex issue with producers, pipelines, distributors, and consumers (both residential and industrial), we concluded that any proposal to move from a regulated to a free market must be founded on three key principles:

(1) Freedom to negotiate new contracts

(2) Elimination of disincentives to produce and sell low-cost gas, and

(3) Consumer protection

Freedom to Negotiate New Contracts

Our proposal eventually will eliminate the wellhead gas price controls that have caused so many problems over the past years, and it offers a free market now to parties who choose to accept it. Removing gas price controls at the wellhead will result in a much more flexible supply and demand response to changing economic conditions. Under the proposed legislation, any new contracts for natural gas purchases may be negotiated, and existing contracts may be renegotiated, at the option of the contracting parties, and all these contracts will operate on whatever terms to which the parties agree. As an incentive to renegotiation, either party will be allowed, beginning January 1, 1985, to opt out of any pre-enactment contract.

Elimination of Disincentives to Buy and Sell Low-Cost Gas

The proposed legislation will allow take-or-pay purchase requirements to be reduced to 70 percent at the option of the purchaser (pipeline). This will give pipelines the flexibility to reduce their required takes of high-cost gas and to replace them with lower cost supplies that now are being shut in. The proposal thereby results in a more reasonable, less expensive mix of gas being produced and sold.

A contract carriage provision has been proposed that both eases the impact of a take-or-pay reduction on producers and serves to increase competition in the gas market. Producers are allowed to sell to any willing buyer that amount of gas removed from take-or-pay provisions or any production not previously under contract, and the interstate pipeline normally servicing the producer will be required to transport this gas at incentive rates. Increased competition among producers and pipelines results when producers are assured transportation to any distributor, major gas user, or transmission company offering a market for gas.

Incentives to increase gas production also will be improved by allowing gas uses currently banned or discouraged by Fuel Use Act restrictions. The gas market also will benefit from the proposed removal of incremental pricing restrictions. Removal of these restrictions can moderate or reverse apparent losses in industrial load by allowing gas prices to industrial users to compete more effectively with other fuels. Such a change benefits everyone -- industry can buy gas at competitive rates;

and, with more industrial users on the pipelines, residential consumers bear less of the fixed costs of the gas supply system.

Consumer Protection

We fully expect that under the Administration's legislative proposal, prices actually will decline. However, we do not expect consumers to rely on our analysis solely as a matter of faith; therefore, we examined a number of options designed to guarantee consumer protection against unreasonable natural gas price increases beyond those attributable to inflation.

As our evaluation progressed, we concluded that the two most promising initiatives were (1) to restrict pipelines from the automatic passthrough of all wellhead price increases above inflation; and (2) to place a free-market cap on contracts yet to be renegotiated. These provisions work as follows:

Current regulatory provisions permit interstate pipeline companies immediately to pass through all purchased gas increases in their semiannual PGA adjustments. Under the Administration bill, any purchased gas cost increases that exceed the rate of inflation will not be allowed to pass through immediately and must be examined by the FERC in a public hearing process with appropriate standards.

As further protection to consumers, we propose a "gas cap" based upon the average price of gas purchased through new and renegotiated contracts following enactment. The gas cap would apply to all presently existing producer contracts until they are renegotiated or expire or until January 1, 1986, whichever occurs first. We do not believe that, in general, producers should be allowed to charge more as a result of a regulated environment than they would receive in a free, competitive market. This provision will ensure that the current environment of declining energy prices benefits consumers.

Such a combination of provisions protects consumers by assuring them there will be no opportunity for unwarranted price increases to affect them during the transition period.

As we have moved toward our goal of providing a free market for natural gas, we have been convinced that the three principles described above are integral to any comprehensive approach toward resolving this issue. Freedom to negotiate new contracts in a free market environment, and away from the distorted incentives of price controls, is essential to any solution to the current contracts problems. Elimination of current disincentives to produce and sell low-cost gas is essential to providing consumers with the lowest priced mix of gas supplies and the most efficient use of our natural resources. While taking all the actions necessary to adhere to these principles while moving to a free market, it is essential that we assure consumers that they are protected from unwarranted price increases during the transition.

PROVISIONS OF S.615

I now will turn to a more detailed discussion of S.615. Although the bill has many complex provisions, the basic intent is simple: to assure that American consumers have an adequate supply of natural gas at a reasonable price. The bill seeks to achieve this objective by removing regulatory requirements that have led to the inefficient allocation of supplies and to artificially high consumer gas prices.

Title I: Purchased Gas Cost

Title I will impose a moratorium until 1986 on the automatic passthrough to natural gas customers of price increases that result from an interstate pipeline's paying higher prices for natural gas. An interstate pipeline will not be able to increase the price to its customers to reflect higher acquisition costs for natural gas unless it can prove to the Federal Energy Regulatory Commission that a recovery of such costs is just and reasonable and that such costs were incurred prudently. In an important departure from present practice, the bill prevents the Commission from putting rate increases based on higher acquisition costs into effect subject to refund. This departure is warranted by the need to provide consumers an additional assurance against unreasonable price increases following the enactment of this legislation.

In determining whether to allow the passthrough of higher costs, the Commission would be required by statute to consider the availability of lower priced gas and the need of the pipeline to acquire the gas in order to render adequate service to its existing customers. The Commission also can consider other factors, including the physical depletion of old gas. To minimize the time a pipeline must wait to find out whether the passthrough of any costs in excess of inflation will be allowed, a special Commission proceeding will be established to review applications concerning these costs. The Commission must adopt rules for these proceedings that will expedite decisions.

The passthrough moratorium will not affect all increases to a pipeline's rate; it will affect only increases in the purchased gas cost component of the rate that exceed the pipeline's "allowed rate" for purchased gas costs. A pipeline's "allowed rate" will be the average price per million Btu's that the pipeline paid for gas delivered to it during the month preceding the enactment of this bill plus an "adjustment amount" to reflect inflation. The "adjustment amount" will be the same for each pipeline. It is calculated by multiplying the national average pipeline wellhead cost by the GNP price deflator and allowing this amount to be added to each pipeline.

In designing the moratorium, we were mindful of the concerns of pipelines with large supplies of old gas. These pipelines believe they will be at a disadvantage, because their sources of low-priced old gas are being depleted physically, while their average acquisition price is increasing as contracts for old gas are renegotiated to reflect the market price. We believe their concerns will be alleviated to some degree by the downward price pressure of the free market. However, we also decided to base the inflation adjustment factor on the national average cost of gas rather than to make it pipeline specific. This action is intended to give pipelines with gas costs below the national average more flexibility in renegotiating contracts for old gas and in acquiring new sources of gas. In addition, as I mentioned previously, the Commission may consider physical depletion as a factor in determining whether to allow a passthrough. The Commission also will be required to adopt procedures for expeditious handling of applications to pass through purchased gas costs covered by the moratorium and could at the same time develop specific procedures to deal with the depletion of old gas. We believe this approach offers more flexibility in dealing with this problem than attempting to devise a depletion factor to be included in the allowed rate.

The proposed moratorium focuses on rate increases based on purchased gas costs because pipelines can bargain with producers over these costs and, with the passage of this bill, they will be better able to stabilize and reduce these costs. We realize this moratorium will not cover all rate increases because a pipeline's rate is based on factors in addition to purchased gas costs. These other factors relate mostly to fixed costs, such as costs for overhead and physical facilities, over which the pipeline has more limited flexibility. In many instances, the rate increases based on these factors occur because the pipeline has lost customers and the fixed costs must be spread over a smaller amount of gas. I believe that the best way to prevent rate increases that result from load loss is to make natural gas prices competitive with alternative fuels.

In addition to the moratorium, Title I addresses the concern that market forces may not be a sufficient safeguard against a pipeline's favoring its own production or that of an affiliate over cheaper gas. Title I establishes a rateable purchase requirement for interstate pipelines. Under this requirement, an interstate pipeline may not recover any costs associated with gas the pipeline acquires from its own production or that of an affiliated producer to the extent that it takes such gas at a higher percentage rate than it takes any cheaper gas.

I want to emphasize this rateable purchase requirement relates to contemporaneous actions by a pipeline. This concept is included in the rateable purchase requirement to indicate that the requirement is not a purely mechanical rule, but, rather, a flexible rule that contemplates compliance based on a pipeline's actions over a period of time.

I believe this provision is the most effective means of assuring that a pipeline does not favor its own production or that of an affiliate because it eliminates any incentive to do so when cheaper gas is available. We considered a requirement that pipelines acquire the cheapest available gas and decided that such a broad prohibition was unnecessary, as well as administratively infeasible. Once pipelines are exposed fully to a competitive market, there is no reason for them not to seek the cheapest available gas. Moreover, the Commission has stated that it will consider a pipeline's purchase practices in general rate cases; and, in the special proceeding on costs covered by the moratorium, the Commission will be required to consider explicitly the efforts of the pipeline to secure the lowest priced gas available.

Title II: Removal of Wellhead Price Controls

Title II provides for subjecting all first sales of natural gas to the competitive forces of the free market. The general rule will be that natural gas sold under new, first sale contracts or under contracts amended after this bill is enacted is free from all wellhead price controls. This will permit natural gas prices to be established immediately in accordance with market forces and not by the existing artificial NGPA price ceilings. At the end of 1985, all remaining price controls will be removed, thus ending the Federal Government's involvement in establishing wellhead prices for natural gas.

We considered alternative methods of terminating price controls and decided this method was preferable to any other. One alternative would have been to increase current NGPA price ceilings for so-called old and new gas on a ramp that would reach the market price on a specified date. This alternative has many drawbacks, including the fact that some NGPA price ceilings already exceed what we believe the current market price to be. Another alternative would have been immediate decontrol. Although this approach is appealing, I believe our approach is better because it immediately decontrols gas that first enters the market after passage of this bill, gas for which an existing contract expires, and gas that the producer and purchaser agree to decontrol. Our approach avoids the practical problems of renegotiating the price terms for every natural gas contract at the same time. In addition, the experience during this gradual decontrol will allow producers and purchasers to bargain more effectively and realistically during 1985, when either party to an existing contract can terminate it, thus decontrolling the gas subject to that contract.

The Administration's bill will apply to all domestic gas, including old gas. I know many believe that old gas should remain subject to price controls forever. We strongly urge Congress to eliminate the controls on this category of gas. Controls on old gas have not worked to the consumer's advantage under the NGPA. Continuing controls on old gas will have many harmful effects. The cushion provided by old gas has led many purchasers to bid the price of deregulated gas above the market price, providing an economic advantage to those pipelines with large, old gas cushions and disadvantaging other pipelines. Continuing controls on old gas will mean continuing distortions in the prices paid for deregulated gas, pushing them to levels well above those that otherwise would clear the market. This could disadvantage those pipelines with small, old gas cushions in bidding for future supplies. In addition, the operation of take-or-pay provisions in newer, higher priced contracts has led pipelines to cut back on older contracts, thereby shutting in some low-cost gas. Moreover, the low price advantage of old gas has been lost for most consumers, and it will continue to be lost as the prices are rolled in with above-market prices for other categories of gas to reach a market-clearing average.

To date, there has been little incentive to produce the maximum quantities of old, lower priced gas so as to reduce the overall price to consumers. In fact, under the NGPA all of the incentives have been reversed -- bringing higher priced gas into the market. We believe the consumer and the economy as a whole should have the economic advantage that would flow from producing these lower cost reserves first.

Title III: Transitional Price and Contract Provisions

The Administration's bill provides a transitional pricing mechanism for natural gas until it is freed by the parties from price controls. Pending renegotiation of contracts, or January 1, 1986, whichever occurs first, gas that currently is price controlled, except section 107 gas, will receive the lesser of the maximum lawful price under any existing section of the NGPA and the "gas cap price." The gas cap price will be the average price of natural gas under recent new or amended contracts that reflect market prices. I will explain the gas cap price in more detail later. Section 107(c)(5) natural gas, including tight sands and other types of gas, will be capped at the applicable maximum lawful price under the NGPA for such gas in the month this bill is enacted. However, the Commission will retain its current authority under section 107(b) to lower the incentive price that such gas currently receives; and, if it does so, the new, lower price will be applicable. The Administration's bill will remove controls from section 102 gas, certain section 103 gas, and certain intrastate natural gas on January 1, 1985, as currently scheduled under the NGPA. However, during 1985, all these categories of gas cannot exceed the gas cap price, unless the gas is sold under a new or amended contract.

In addition, a price cap will be imposed for high-cost section 107(c)(1)-(4) deep gas sold under contracts in effect on the date this bill is enacted. The cap will be the higher of the following: the contract price in effect on the date of enactment of this bill or the gas cap price. The cap will be effective from the date of enactment through December 31, 1985. However, the cap will be removed immediately from any gas that qualifies for free market prices because of the general rule that decontrols any gas sold under a new or amended contract.

The gas cap price will reflect the current market price for natural gas and thus would eliminate distortions under the NGPA by which maximum lawful prices act as "price floors" preventing gas prices from responding to downward market pressures. This occurs because contract clauses escalate contract prices to the highest allowed Federal Government rate, without regard to market pressures. To reflect changing market conditions, the gas cap price will be a volume-weighted rolling average of prices. This average will be based on the prices estimated to be paid for gas estimated to be delivered during the second, third, and fourth months before the month for which the gas cap price is published. Only gas delivered during the first three months of contracts newly entered or amended following enactment will be included.

The bill also smoothes the transition to a free market by allowing parties to modify and even to terminate existing contracts for gas produced in the United States. Although there is no doubt that Congress has the constitutional power under the Commerce Clause to modify or terminate existing contracts, the inclusion of these provisions was an especially difficult decision because of this Administration's philosophical commitment to the sanctity of contracts. However, after examining the market and listening to many complaints about current contracts, it became clear to us that decontrol would not work unless parties could free themselves from contracts entered into under the expectation of permanent Government price controls. These contracts currently are distorting the natural gas market and causing gas prices to increase at a time of abundant supply and falling prices for other energy sources. These contracts have turned NGPA price ceilings into "floors" and, when combined with the automatic price increases inflexibly built into the NGPA, have created the present predicament.

The Administration's bill will address the contract problem in two ways. First, it will permit purchasers to reduce their take of domestic gas under a contract to 70 percent of well deliverability, without incurring any obligation to pay for the gas not taken. This legislative proposal concerning take-or-pay contract provisions will free purchasers to respond to market signals and reject deliveries of high-priced gas that is not marketable.

A producer will be able to protect its ongoing financial requirements by terminating the contract with respect to the volumes refused. If a producer terminates a contract in this manner, the refusing purchaser will be required to transport for the producer the volume terminated pursuant to this provision. The pipeline receives its normal rate for this transportation plus 5 cents per million Btu's. This 5 cents is reserved for the pipeline's shareholders.

The other contract provision in the bill will allow either party to a contract that is in effect when the bill is passed and that is for gas produced in the United States to terminate that contract in 1985 if the contract has not been renegotiated previously. This market-out provision is intended to assure that the price of gas reflects market conditions and to allow parties to contracts to solve problems, such as take-or-pay or oil-parity clauses, without the Federal Government imposing an arbitrary solution.

Any party that received a benefit under the contract before its termination must pay for that benefit, and any party that received payment for a benefit that was not furnished or performed before the effective date of termination must make restitution of the payment, in cash or in kind, in accordance with the contract. This provision will assure that parties to a terminated contract resolve on an equitable basis any questions concerning advance payments, prepayments, or similar matters. It is intended that any payments returned to a pipeline under this provision will be passed through to the pipeline's customers to the extent that the pipeline's rates previously reflected the payments. Any pipeline that was a party to a contract terminated under this provision will be required to transport a volume of natural gas not to exceed, on an annual basis, the largest volume delivered under the contract during any 12 consecutive months in the 36 months immediately preceding termination. The pipeline will be compensated as I have just described for the take-or-pay provision. This provision will permit a producer to seek another buyer for the gas sold under the terminated contract even if the former purchaser controls all the transportation facilities servicing the producer.

Title IV: Removal of Impediments to Interstate Movements of Gas

Title IV is designed to facilitate transactions between the interstate and intrastate markets without subjecting those transactions to certification procedures under section 7 of the Natural Gas Act, and without requiring intrastate companies to become jurisdictional "natural gas companies" under the NGA. Sections 311 and 312 of the NGPA were designed to permit the then existing "bubble" of gas in intrastate markets to flow into interstate markets that were facing gas shortages. Our bill will amend these NGPA provisions to allow natural gas to flow both ways to correct imbalances in any market.

Our bill will establish the principle that, in most instances, intrastate pipelines should not be subject to the Commission's jurisdiction just because the intrastate pipeline acquires gas produced in another State, as long as there is no regulatory gap concerning the sale and transportation of such gas.

Our bill also will prohibit the Commission, in exercising its jurisdiction over any gas under either the Natural Gas Act or the NGPA, from discriminating against either intrastate or interstate purchasers.

Finally, Title IV of the Administration's bill will provide that, upon application by a producer or a producer's customer, the Commission shall order an interstate pipeline to transport gas in behalf of the producer and purchaser, under such terms and conditions as the Commission determines to be just and reasonable. This "contract carriage" section is intended to open the natural gas market to the operation of the laws of supply and demand to the fullest extent possible by encouraging producers and users of natural gas to deal directly with one another. I believe this provision will aid consumers in two important ways. First, it will allow local distribution companies and end-users to negotiate directly with producers for supplies of natural gas, thus assuring that market signals are reflected at the producer level. Second, this provision should encourage industrial consumers to negotiate lower prices for natural gas, rather than switching to oil, and thus generally should prevent the increase in rates that results from load loss.

In consideration for transportation under this provision, the pipeline would receive 5 cents per million Btu's in addition to the normal transportation rate that the pipeline would receive under the Natural Gas Act for such transportation. The 5 cents would not be credited and flowed back to the pipeline's customers; rather, it would be reserved for the pipeline's shareholders. Except for the special treatment of the 5 cents, the revenue from transportation under this provision would be treated in the same manner as revenue from transportation under the Natural Gas Act.

Title V: Removal of Demand Restraints

Title V also addresses the problem of load loss. Incremental pricing will be eliminated. Although incremental pricing was designed to aid residential consumers by shifting the costs of expensive gas to industrial users, there are many indications that it has hurt residential customers by driving industrial users away from natural gas. As a result, residential customers have had to bear not only the costs of expensive gas, but also a greater percentage of the pipelines' fixed costs.

The bill also will repeal several regulatory programs relating to the use of natural gas and petroleum under the Powerplant and Industrial Fuel Use Act of 1978. These programs, which have been in place since 1978, were designed in part to place limits on natural gas and petroleum use in new facilities and certain existing facilities because at that time it was thought market forces could not direct fuel choices that were in the national interest because of the price regulation then in effect. As a result of this price regulation and its concomitant distortion of the free market choices, the use of natural gas and petroleum was prohibited in new electric powerplants and new industrial boilers. Further, the use of natural gas was severely limited for outdoor decorative lighting. The Secretary of Energy also was authorized to prohibit the use of natural gas or petroleum in existing coal-capable electric powerplants and large industrial boilers and the increased use of petroleum in existing electric powerplants. As originally enacted, the Fuel Use Act also required electric utilities to stop using natural gas as a primary energy source in 1990.

The repeal of these programs, when enacted as part of a comprehensive natural gas price decontrol act, will enable the private sector to make its fuel choices based on real market prices.

THE EFFECTS OF THE PROPOSAL

Price Effects

Under current market conditions, the legislation proposed by the Administration should cause average gas prices nationally to fall from present levels by between 10 cents and 30 cents per thousand cubic feet in the first year after enactment. The policy initiative will result in prices that are 20 to 40 cents lower than the price level that would occur in that same year under the NGPA. This price decrease represents only a part of the national economic benefits to be derived by moving toward market-determined natural gas prices.

Gas prices will fall largely as a result of an increase in gas production shortly after enactment of the proposal as the current excess in deliverable gas supplies is drawn down. The lower gas prices and greater availability of gas supplies that result will cause gas to compete more effectively with oil, primarily for industrial uses, and cause a reduction in oil imports as some oil consumers switch to gas. We estimate that oil imports would fall below current low projections by 100,000 to 200,000 barrels per day in the first year following enactment of the proposal. This reduction in imports would further contribute to lower world oil prices and lower vulnerability to insecure oil imports.

The proposal also will have a beneficial effect on the economy as a whole. Decreased gas prices will reduce the rate of inflation by a small amount both directly and by reducing the cost of producing other goods and services, the production of which involves natural gas. In addition to the net benefits directly attributable to the policy, real income nationwide will be increased by a small amount as lower gas prices spread through the economy and affect other sectors.

Economic Efficiency

Valuable national resources should be spent in the most cost-effective manner possible. Natural gas that is the least expensive to produce should be produced first. Gas that is more costly to produce should be produced only when the price it receives in the market justifies that expenditure. Currently, under the NGPA, this is not the case. The practice of averaging the cost of different price categories of gas causes high-cost gas to be subsidized by lower cost gas, thereby encouraging use of the high-cost supplies. The Administration's proposal would improve national welfare by increasing the incentives to develop the least costly gas first. This would be accomplished by allowing all existing contracts to be renegotiated in a free-market environment, with negotiating parties determining both the prices and terms of contracts with no regulatory restrictions in place.

The efficient use of national resources also would be enhanced by the removal of fuel use restrictions. Any industry or utility that wanted to use natural gas and was willing to pay the market price for that gas should be allowed to do so. This would benefit gas consumers by increasing pipeline loads and spreading fixed transmission costs over a larger number of users. The removal of this restriction also should provide further benefits to oil consumers by putting downward pressure on oil prices as oil and gas suppliers compete.

This path to a free market allows greater flexibility in the gas market and should prevent the problems of the last few years from occurring in the future. The costs of a transition toward decontrol have never been lower than they are today. This is because the Nation as a whole has sufficient supplies of natural gas, and pressures are toward reducing the price of gas and easing contract terms. Indeed, even under conservative assumptions, our analysis shows that average residential prices are projected to fall in the first year and are expected to remain lower under the Administration's proposal compared with the NGPA until after 1985. Under conservative oil price projections and projections of very limited supply response to the legislative proposal, the more rapid and economic production of gas resources before 1985 under the Administration's proposal may cause residential gas prices to rise back to the NGPA levels in the period between 1985 and 1990. After 1990, the NGPA and policy proposal will bring about roughly comparable prices because the Administration's proposal will induce greater high-cost gas production in the years when such production is economic. Under assumptions of greater supply response to a free market, prices under the Administration's proposal will fall consistently below NGPA price projections.

On its face, the analysis I have described above may cause some to overlook the positive aspects of the Administration's proposal and question why it would not be better to let NGPA play out as scheduled, thereby avoiding these difficult issues. In response to this question, I call your attention to two major points: (1) the conservative assumptions used in the analysis, and (2) the magnitude of the benefits under such assumptions.

It is essential that issues of such importance to the consumer be addressed in as fair and informed an exchange as is possible. Therefore, I instructed the Department's career analysts to take as conservative an approach as was reasonable in measuring the projected effects of our proposal in comparison to current law. The oil prices used range from $31 to $33 in real terms over the 8-year period, levels that are above where we are today and which are higher than many current projections would show. Our assumptions also anticipated a very limited supply response to the proposal (an assumption that proved to be absolutely wrong when the impacts of oil price decontrol were being estimated) and employed low estimates of excess gas deliverability. The combination of these serves to show that we can expect positive results even under very conservative assumptions about market response to the proposed legislation.

Given these conservative estimates, we are projecting that the proposal's benefits to consumers over the 8-year period, compared to what would obtain if the NGPA merely played out, will be at least $7 billion, using a discounted present value calculation. This indicates that a decline in price of only a few cents from that which would be expected under NGPA has substantial effect on costs to consumers. If one assumes that oil prices, for example, might be lower in the near term, the near-term benefits to consumers could be much larger.

We also have examined the possibility, as urged by some, that the partial decontrol provisions of the NGPA be revoked in coming years and that the NGPA price controls be extended indefinitely. Our analysis projects that continuation of price controls would result in wellhead prices that are about 28 cents, or 6 percent, lower in 1990 than those projected under a continuation of the NGPA. However, these lower prices impose a large cost on the economy. Future controlled prices would discourage domestic production of gas and cause from 200 billion cubic feet to 1 trillion cubic feet of curtailments in the late 1980's. Price controls and lower national average prices also would induce relatively higher total demand for gas, causing consumption levels to be higher by 600 billion cubic feet by 1990.

This higher consumption cannot be satisfied by domestic production alone (which is lower under this continued controls case) and must be met instead by an increase of 800 billion cubic feet in higher priced imports of Canadian gas. Thus, by keeping prices to consumers below those in a free market, shortages are created that even increased payments to importers cannot prevent because import quantities are restricted by agreed-upon maximum import authorizations. If import authorizations were raised to eliminate shortages, the United States would still experience a substantial increase in the real resource costs to the Nation of importing gas.

Conclusions of an extended controls case are clear. Maintaining price controls leads to inefficient subsidies to foreign production that would be replaced more economically by domestic production were it not for price regulations. In addition, price controls encourage inefficient consumption of gas by users who would be unwilling to pay the true costs of producing the gas. All these inefficiencies would be exacerbated if the price escalators built into the NGPA were removed.

Comparison With Other Gas Policy Analyses

A paper entitled "An Analysis of Natural Gas Pricing Policy Alternatives" was recently released by the General Accounting Office (GAO). In general, our analysis and GAO's are very similar in projecting the effects of current law and estimating the longer term benefits of a free-market environment. We agree with the GAO findings that the differences between current law and a fully deregulated market in 1985 are not large and that, under current world oil price assumptions, we would not expect large price increases from the partial deregulation mandated by the NGPA.

We do not, however, agree with GAO's conclusion that the differences between the cases are so small that the NGPA simply should be allowed to play out. First, such a conclusion is highly sensitive to oil price projections, and such projections can change dramatically in either direction as we saw in 1978 and are seeing again today. Second, the GAO has not analyzed the Administration's current proposal under currently projected market conditions. Where GAO shows near-term prices increasing, we show them decreasing. Such differences appear to be only a function of differing market assumptions and proposal specifications. Once GAO conducts an analysis on more current information, we expect the conclusions to be quite similar.

Another analysis of gas policies was recently released by the Consumer Labor Energy Coalition. The C/LEC estimates of sharply increasing gas prices and consumer costs as a result of decontrol legislation do not apply to the administration's proposal for several reasons. First, the Coalition is analyzing a hypothetical accelerated decontrol proposal, which does not take into account the administration's handling of several elements, such as the cap on indefinite price escalators and the PGA moratorium. Second, the C/LEC analysis understates the impact of the current gas surplus and relies on an arbitrary relationship between gas and crude oil prices that is too high by 10 to 20 percent, thereby exaggerating the impacts of decontrol. Third, C/LEC expresses impacts in nominal rather than real dollars, further exaggerating their results. Finally, the Coalition's report builds more than half of their consumer cost increases on "indirect" macroeconomic costs that are based on assumptions that decontrol will cause gas prices to rise. Our analysis indicates just the opposite -- that gas prices will fall -- and therefore we estimate that consumers will receive macroeconomic benefits from deregulation of the gas market.

CONCLUSION

It is clear that 45 years of natural gas regulation have had dramatic effects on our economy. In the mid-1970's, when prices were held below market levels, the Nation faced severe curtailments of supply. In recent years as oil prices have fluctuated, the market has been unable to respond. Currently, the Natural Gas Policy Act is causing natural gas prices to rise in spite of an oversupply of deliverable gas, declining oil prices, and a low rate of inflation.

The fact that current law will continue to cause prices to rise over the next several years, regardless of the prices of competing fuels, is a situation we cannot allow to continue.

The proposed natural gas legislation will benefit consumers by creating a system in which gas prices can be responsive to the pressures of the market. Through this approach to the free market, the proposal will protect consumers from uneconomic natural gas price increases while eliminating regulatory barriers that prevent natural gas from being purchased, distributed, and used efficiently.

This is neither a partisan issue nor one we can afford to delay addressing. We have proposed the most balanced piece of legislation we could conceive. We are convinced it will work well and will work in the manner I have outlined to you here. I sincerely hope that this Committee will give this issue its most serious and expeditious consideration, and I am available to address any and all of your questions and comments.

The **Chairman**. Thank you very much, Mr. Secretary.

We will operate under the 10-minute rule on the first round of questions. If the clerk will remind each of us of when our time has expired, I would appreciate it.

Now, Mr. Secretary, let me ask you a question about one of the most controversial portions of the bill, and a major feature of the bill, the decontrol of old gas.

The bill would permit the producers of old gas to abrogate their contracts on January 1, 1985. The argument is made that virtually all old gas contracts would be abrogated, that the producers would sit back and wait for the highest bidder, and they would eventually sell the gas at a much higher price.

Mr. Secretary, if producers are permitted to abrogate their contracts, to what extent do you think that they could afford to hold their gas off the market and wait for prices to increase before resuming their production?

Secretary **Hodel**. Mr. Chairman, I don't think that would be a widespread effect. Obviously, it is a matter that could be disputed comfortably because it is a matter of opinion. Nobody really knows, and you can run all the analyses you want on both sides; but let's consider what happens in that market.

First of all, the right of abrogation for the year beginning January 1, 1985, is mutual. It is a right of abrogation on the part of pipelines and of producers, so it isn't just old low-cost contracts that may be subjected. It is also newer high-cost contracts that may be subjected to that abrogation.

We think the importance of that provision is not that there will be many abrogations beginning January 1, 1985, but, rather, it will provide a tremendous incentive for parties to negotiate responsibly a price which is the market price, or which moves toward the market price.

I think what actually will happen is you will have, as I have indicated, numerous producers. Almost all of those producers have some high- and some low-cost gas. The argument is made it is skewed toward the majors owning a higher percentage of low-cost gas.

That may well be the case. But the net result is, in approaching a pipeline to negotiate following the passage of this bill, a producer has an incentive to try to move the price up as far as he can; but at the same time there will be tremendous pressure to bring down his newer higher cost gas prices, and I think probably neither will quite reach the average.

The **Chairman**. Your bill would impose a strict limitation on the ability of pipelines to recover increases in their purchased gas costs?

Secretary **Hodel**. Yes.

The **Chairman**. The result would be an individual pipeline would pay higher prices for old gas only to the extent that it could fully offset those higher costs by reductions in its purchases of expensive gas. Is that the theory?

Secretary **Hodel**. That would be their effort. It would have to be their effort because, except for inflation, they would not be permitted to pass increased costs through. If you were negotiating for the pipeline, you would argue strongly to the producer that he was jeopardizing the entire financial future of the pipeline if it were faced with prices above what could be passed through without the FERC public review process provided in the bill.

The CHAIRMAN. Well, is it your belief, then, that producers who abrogate old gas contracts might not be able to sell the gas at greatly increased prices?

Secretary HODEL. Yes; that is my belief.

The CHAIRMAN. Simply because of the limitation on the ability of the pipelines to pass that increase on through, and therefore, their unwillingness to renegotiate or pay the higher price.

Secretary HODEL. And the fact that, at the present time, there is a substantial excess supply in the market. We have a unique situation existing right now. There is a supply excess, and that makes it more difficult automatically to go out and move prices up, if that is someone's desire.

The CHAIRMAN. How about the argument that is made by some that we have in effect reduced the incentive to drill for new gas simply because we have reduced its premium in the market. It can't be rolled in against the price of the old gas; thus we have substantially reduced the incentive to go out and drill and explore for and find new gas.

What does that mean toward future supplies?

Secretary HODEL. If we move directly to the free market, it means that the lowest-cost gas would move to the market first. As that gas depleted, and we don't know the rate at which it will deplete, all the estimates of it under NGPA have been that, at the end of the Natural Gas Policy Act in 1985, we would have approximately 40 to 50 percent of the gas prices still controlled, old gas still controlled, and that, by the year 1990, we would still have 20 percent of the gas controlled.

I would submit, Mr. Chairman, that the chances are very much better that, if we go to a free market approach, we will find out there is more potential low-cost gas than anybody today believes; but gas is not low-cost or high-cost; gas is a continuum. As we know, as the price chart indicated, there is gas which comes in at varying costs right on up to extremely expensive deep gas.

It seems to me that the incentives will be to develop lowest cost gas supplies and to bring them to this market. Then, as the price provides an incentive, the next phase will be to develop the next least costly gas, and so on.

Today's system has had the direct effect of encouraging investment in unregulated deep gas, which comes to the market at exorbitant prices by anybody's standards today.

The CHAIRMAN. Mr. Secretary, the bill doesn't touch the question of imported gas, whether it be from Canada, Mexico, or by LNG from other suppliers.

Why that exception?

Secretary HODEL. You are correct, Mr. Chairman. It does not, and that was no oversight. We intentionally did not do that, knowing that there were several Members of Congress who have strong opinions about how that should be handled, and recognizing that we did not have a clear picture of how to deal with it in legislative language. Further, I believe strongly that the Canadians, who are the largest suppliers, clearly desire to be competitive in this market. We need to recognize that today the Canadian Government, if it adjusted the price of their natural gas to the United States down from the present price of $4.94 per million Btu's, would be in a position of telling the Canadian citizens they were proposing to sell gas in the United States at prices less than gas was being purchased in the United States from domestic wells. In certainly some cases, that would be true. That is a very difficult political position for them to take.

However, I see two encouraging factors—first, there are producers in Canada who want more access to the U.S. market; and second, the Canadian Government recently has indicated it is willing to make 11.5 trillion cubic feet additional supply available.

Now, knowing the current situation in natural gas in the United States, they clearly are signaling that they are intending to be competitive, if we will rationalize our market, and the price of gas in this country is well below $4.94. I am convinced the Canadians are prepared to be competitive as they want a share of that market at a competitive price, and I think that would happen even without legislation.

The CHAIRMAN. You mentioned the Canadian willingness to increase the exports, or at least to make more available for export. Is that a virtual doubling of the quantity that they have identified as available for export?

Secretary HODEL. Mr. Chairman, I don't have that figure at my fingertips.

[The information follows:]

Of the additional 11.4 trillion cubic feet of gas authorized for export, 9.2 trillion cubic feet have been identified for the U.S. market. Previously authorized volumes of 11.3 trillion cubic feet have not yet been exported to the United States. Thus, the new authorization represents nearly a doubling of Canadian gas available for export to the United States.

The CHAIRMAN. My understanding is that it is about a doubling of the previously identified amount.

Thank you very much, Mr. Secretary. I will return to some questioning, after I have given other members of the committee an opportunity to ask questions.

Senator Johnston.

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Secretary, first of all, let's deal with the passthrough.

Under the passthrough mechanism, a pipeline cannot pass through costs to exceed its acquisition costs, plus inflation.

Now, unless they get FERC approval, you provide a special procedure for FERC with rather vague standards which say just and reasonable, but you take another factor.

My guess is the delay for those proceedings would be something like a couple of years, or maybe a year, at best.

You allow for no cost of money in the meantime. Now, my question is this: How can a pipeline pay what it may not be able to collect?

And, that is to say, the pipeline, if it is going to make a contract of that pipeline average cost, it may not be able to collect it, so how can it pay it, if it is not sure it can collect it, or if it can't that it can't get the cost of the money in the meantime?

Secretary HODEL. Senator, it can't pay beyond what it can collect. I am advised, in the case of some pipelines, that 70 to 80 percent of their costs is the price of gas.

So, put it in this context. If 80 percent of their cost is gas, and the pipeline agrees to pay a price 20 percent above the allowable passthrough a and it can't pass that through, that 20 percent of 80 percent is 16 percent of their total gross revenues. At 16 percent, I am advised it is probably nearly equal to the net return on the pipeline investment.

Suddenly, you find for 6 months or 1 year or 2 years, depending on how long it takes this process to go on, that the pipeline basically has to eat its entire net; and of course, if the figure I used were greater, it would be worse.

This is precisely why the pipelines are extremely concerned about this provision. I understand that and I am concerned about it. But, in choosing between the alternatives which we think existed, we felt that this does put pressure on pipelines not to permit that price to exceed their average cost plus inflation. I think this is not recognized by the critics of this proposal, at all. They simply ignore the importance of this.

Senator JOHNSTON. Well, aren't you saying, then in effect, that there will be no renegotiation prior to January 1, 1986 for, section 104 contracts?

Secretary HODEL. No. I think what I am saying is there will be significant renegotiation for several reasons. First of all, again, if you and I were in a contract, as a producer and a pipeline, neither of us—assuming it is any significant part of the gas that is passing through that pipeline—ought to be willing to wait until January 1, 1985 to find out if the other is going to terminate the contract.

That is a fairly high-risk bluff to run. I think there would be a great incentive, on that basis, to start talking initially.

Second, while we are——

Senator JOHNSTON. But what we have just said though, that he cannot pass on his additional costs; he may have to wait a year or two to find out whether he can; so, therefore, he cannot; so, how can he renegotiate?

Secretary HODEL. What I am assuming is there is not a single supplier to the pipeline. I don't know of any cases where there is only one producer supplying the pipeline—you have a total array of prices out there, coming into that pipeline.

What I would have to do, as the pipeline, is to go out and start talking to every one of those producers, including the high-cost producers. I would have to alert them to the fact that, if we could not reduce their price, I would be abrogating their contract.

Second, those that are——

Senator JOHNSTON. But the high cost, though, are only a very small percentage, as compared to the low cost?

Secretary HODEL. They can be a very significant part of the cost for the pipeline, however. You may have a pipeline with 40 to 50 percent of old low-cost gas in the pipeline and only 6 or 7 percent of the new gas. Yet, the new gas may equal 20 percent of the total cost of gas for the pipeline, and the old gas would represent 30 percent or less of the total gas cost for the pipeline.

So, it seems what has to happen is the pipeline must go out and talk to the producers. The producers, of course, have an incentive as well because, in some cases, these low-cost producers are not able to get their gas to the market at all today.

So, there is an incentive on the part of the producer to try to get his gas to market, first and second, to get to market at the best price available. The pipeline is saying that best price available is going to be affected by what I am able to negotiate with my high-cost contracts over here.

I am not willing to run the risk of the jeopardy I would be placed in if I have to go through that public proceeding.

Senator JOHNSTON. I believe if you look at it pipeline by pipeline you will not find symmetry between the high cost or the low cost, either in total amounts or certainly not in Mcf's. If you are going to wait to renegotiate your 104 until after you have got a deal on your 107, I think January 1, 1986, is going to be already past.

And, if you don't renegotiate, then doesn't that set the scene for a huge fly-up, come January 1, 1986; and isn't that a great temptation for the reregulators here in the Congress?

Secretary HODEL. If the market were to work as you suggest that it would work, and if there is an obvious postponement of price increases until January 1, 1986, when we would cease to control those prices, clearly that will be an open invitation to Congress to come back and regulate, just as I indicated.

That is the risk that both parties to that contract also run if they do not negotiate in some responsible way with regard to that average price of gas.

Senator JOHNSTON. Well, I would like to look into the passthrough. I have some more questions with respect to that. But let us talk about the gas cap.

How much of a rollback in section 102 do you envision that there would be with the gas cap?

Secretary HODEL. The current price of 102 is approximately $3.35. We think the current average in the country would be between $2.75 and $3.25, probably under $3. So, there would be a significant rollback of the 102 price.

Senator JOHNSTON. You mean the average price of 102 is now $2.75 to $3.25 or would be?

Secretary HODEL. The current price of 102 is approximately $3.35.

Senator JOHNSTON. You mean the current NGPA price?

Secretary HODEL. Yes; the average price of gas in the country, we presently estimate, would be between $2.75 and $3.25. Probably, it will come in at slightly under $3.

Senator JOHNSTON. Is it not true that when you include renegotiated contracts as part of the weighted average prices used to determine the gas cap, that that is going to bring your gas cap down substantially, Most of those renegotiated contracts are going to be 104 contracts, but they are not going to rise to the national average immediately. Is that not going to bring that gas cap down even lower than the national average cost of gas presently?

Secretary HODEL. That is a possibility. As you know, we talk about a volume weighted average for the price of gas. It depends partly on how much renegotiating of the high cost contracts also is going on, which may help to offset that.

But I would like to point out that I tend to agree with your assumption, which I think is valid, that the old gas prices would not rise promptly and immediately to the average national price. But there would be an effort to move in that direction, and depending how well that moves would be depending on this negotiating process. So it would have that effect.

Senator JOHNSTON. I believe that this gas cap would even be lower than what you say, I think that it would be a very significant rollback in section 102 gas. Is there not first of all less motive to negotiate, to renegotiate on the part of a purchaser of gas; and if so, would there not be a lot less renegotiation, and another scene set for a fly-up from January 1, 1986?

Secretary HODEL. There obviously is less apparent motivation for them to negotiate. But, the pipelines must be concerned about their supply over time. If they are too harsh with the producers, and too harsh is going to be a judgment call on the part of negotiators—rather than our trying to pick that figure and set that number, we say that is what the market ought to be setting—but if they are too harsh, the suppliers are in a position to say, "I am going to go out and look for an alternative purchaser."

And, that is where, as the gas pipeline chart that I showed you with all of the options for pipelines illustrates, the opportunity to deal directly with industrial users presents itself for producers who feel they simply are not getting anywhere with their pipelines.

It is a matter, again, of some concern to pipelines, I must say.

Senator JOHNSTON. Would it not be more fair when you calculate the gas cap price to make it a weighted average not of new and renegotiated, but of just new contracts? That way you could get a true market reflection, if you put a cap lower than NGPA, or new market sales.

Secretary HODEL. I do not know that it would be more fair, Senator. It clearly would tend to keep the price up higher. But, it necessarily would not be more fair. Part of the problem we have today, with what we call the cushion, is the existence of the low-cost gas in some pipelines has permitted those pipelines to turn around and agree to pay high prices, which are clearly way above what the market would indicate, because all they have to do is average down to the market. What we are trying to do is, obviously over time, move to the situation where all of those contracts tend to move toward the market, instead of having some in there at $10 and $11, which has had a terribly deleterious effect.

So it seems to me it would be a judgment call—it would clearly tend to keep the price higher. It would avoid the risk that, if the earliest negotiated contracts were old gas, and they only came up a few cents, they could have a tremendous downward leverage on the pipeline 102 prices. I understand that possibility under this proposal.

Senator JOHNSTON. My 10 minutes is up. I have some questions in writing that I would like to submit.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Secretary, I trust that you would agree with the proposition that it is fair to say that the reason that Federal and State governments grant monopolies to and then regulate the rates of interstate pipelines and gas utilities is for two basic reasons.

First, we desire to achieve the economic efficiency that goes with having one as opposed to numerous gas companies running several gas mains down every street or in every market area. And second, having granted that kind of monopoly status to such companies, we regulate their rates in order to avoid the extraction of monopoly profit from the consumer to the distribution company or the pipeline.

If you do accept that, and I do ask you to accept it for the purposes of this discussion, then after January 1, 1986, is there not a problem created by not having some real and substantial regulatory check on pipeline purchased gas cost; or alternatively, how without such a regulatory check will we avoid having the gas producers extract the very monopoly profits which cause us to regulate the pipelines and the utilities in the first place?

Secretary HODEL. Clearly, Senator, with regard to your first premise, the distribution companies are monopolies, and are regulated. The pipelines, particularly early in their career, were essentially monopolies. There is much more potential competition today than I think we would have expected because of the multitude of pipelines that have been constructed.

Still, we have a regulatory structure for all of their costs, actually including gas prices. But, because of the way the purchased gas adjustment operates, it is always after the fact; and there are two very tight restrictions on what FERC is able to look at there.

It seems to me that the Federal Energy Regulatory Commission has the ability to review the rate proposals that pipelines present down the road. If we can get to the point where this potentially useful productive free market can operate at the production end of the scale, we already have in place regulators who are charged with the responsibility of doing precisely what you indicate.

That is something that is always amenable to congressional revision and direction, as far as what FERC should be doing there.

Senator HEINZ. So you accept the proposition that there is a need for some kind of oversight and regulation after January 1, 1986 to insure that either the monopoly or privileged status of pipelines and distribution companies do not foul the marketplace up, and do not extract monopoly profits from the end use consumer?

Secretary HODEL. I believe that exists, yes.

Senator HEINZ. Now you have mentioned that you have pipeline accountability standards. And I would like to focus on those provisions for a moment. Now as I understand the bill, the first section is called the limitation on passthrough of certain purchased gas costs.

And in that sense, the bill provides a measure of new oversight by FERC of pipeline purchased gas costs. Now regardless of the merits of the FERC regulatory oversight in that new section, what I am curious about is where is the effective oversight of pipeline gas costs when your new section expires on December 31, 1985?

Secretary HODEL. The Federal Energy Regulatory Commission would still have its authority over pipelines. It still will have its fraud and abuse standard, which is existent today in NGPA. We know how people feel about that operation. The effective application of the price constraint will have to be through the marketplace under this proposal.

Senator HEINZ. Now what you are saying is that we are going to be left once again with the NGPA guaranteed passthrough, which is only subject to a fraud and abuse standard, and which I think by your own testimony here today where you recognize many of the problems which we have encountered since 1978 up to the present where the FERC has approved certain kinds of provisions, certain kinds of contracts, allowed what you yourself mentioned take or pay, indefinite escalators, and so forth, all of these things having taking place under the fraud and abuse standard, it seems to me that what you are saying is that same standard will continue to apply after January 1, 1986.

Why is that given the kinds of abuses that you seem to think are taking place, why is that going to prevent those kinds of unwise practices, and abuse or practices in the future?

Secretary HODEL. Because, as has been pointed out by a number of people here today already, the existing situation here is largely created in terms of price by the Natural Gas Policy Act price ceilings, which for all practical purposes became floors. The contracts that were entered into pushed all of these prices up to those levels.

So, you have not had a market at work, absolutely not a market at work; but, what we have at work is Government regulation and price controls. What we have is the Federal Energy Regulatory Commission being asked today to determine that it would be abusive to passthrough Government control prices.

If you change that situation to post-1986, and if the market has worked as we anticipate, the problem will not exist. Well before that, we will know, because of the contracts that are being executed, whether there is a risk of this problem.

If it appears there is a real risk, clearly the FERC proceeding is a possible opportunity to extend and control that. I do not think there will be under this proposal. You will have market prices.

Senator HEINZ. Irrespective of some of the faults of the Natural Gas Policy Act, it strikes me as laying on a little bit heavy to say that all of the problems that we have got, and I will name them in a minute, are the result of the ceiling prices in NGPA.

Secretary HODEL. I did not mean to say that, Senator, if you understood it that way.

Senator HEINZ. I do not understand how take or pay provisions at 100 percent, or in some cases of over 100 percent, are directly attributable to the ceiling prices. I do not understand how some of the other—allowing gas to be priced on a dry as opposed to a wet basis, which is allowed by the FERC is attributable to ceiling prices.

It seems to me that those were regulatory decisions that FERC made, and permitted the execution of between buyers and sellers. Is that not right?

Secretary HODEL. I would assume that is right. It was pursuant to pressures applied in proceedings before FERC pointing out the economic impact on the persons making the presentation of those various proposals, just as you and I and others, during the course of this process, will hear from many who feel themselves affected, whether by your bill or ours.

Senator HEINZ. I would like to return for a moment to the issue of the decontrol of old gas. As I understand the administration's presentation, you said to us a few minutes ago that first the most important thing that you believe that you have got here is consumer protection. And whether we agree or disagree on how effective that is going to be, you are saying that is your first principle?

Secretary HODEL. I said I thought that was the linchpin.

Senator HEINZ. The linchpin.

Secretary HODEL. Because I think that, until we came up with the consumer guarantee, I did not have what I thought was a viable proposal. While I believe the market is ultimately the only way to insure an adequate supply at a reasonable price, I could not conceive of attempting to persuade the Congress of the United States to accept that on faith without some consumer guarantee.

That is why I say that is the linchpin of this proposal.

Senator HEINZ. On the question of decontrol, you and Senator McClure entered into a discussion of why the implementation of decontrol of old gas would or would not result in less exploration and finding of new gas, of additional supplies.

And I believe that your answer to him went something like the decontrol of old gas would encourage people to go out and look for low priced gas. Now my analysis would be that if you do have a free market for gas, as you propose, that first you will get at the distribution end—may I go for 30 seconds, Mr. Chairman. There are a lot of other people. I will withhold this question until later. It will take longer than 30 seconds.

The CHAIRMAN. All right, thank you.

Senator Ford.

Senator FORD. It will take us a long time to look at this hot horseshoe, I am afraid.

Mr. Secretary, there are lots of questions that are going to be asked. And I hate to see this day go by without you coming back again. We may ask you to do that before we get through.

But you have a chart, a visual aid up there for us. And if you look at that chart, you see the transmission costs. And you have pressures under your legislation, and FERC, and others to hold prices down in that middle section.

When you get to the end users, you have the public utility commissions, and others to hold the prices down there.

Where is the pressure on No. 1, the producer?

Secretary HODEL. The pressure on No. 1, Senator, has to occur at the time and the point of negotiation between those pipelines and the producer.

Senator FORD. The producer can sell to anybody that he wants to. He can go out and find a market, and sell to any individual. You release him.

Secretary HODEL. We would release him to look for a market. At the present time, we have a surplus of gas supply.

Senator FORD. If there is an emergency situation, you are going to make that pipeline transport it for him?

Secretary HODEL. Yes.

Senator FORD. Somehow there is going to have to be some fairness in this piece of legislation, and I do not think that it is fair yet. And I think that we are beginning to get to the point where you are making certain parts of it the fall guy, as I see it.

And you get to the other part where they have it all. And you are pushing things back. You are abrogating contracts. You are renewing mortgages and debts at banks. We are beginning to do lots of things.

Because a lot of contracts that were long term are at the bank, and loans are based on those contracts.

Let us just go to your testimony on page 2. You compare the natural gas, oil, and coal markets there. You attribute the rigidities in the natural gas market solely to the fact that natural gas is limited in its ability to compete, because it is now the only fuel that is regulated at the point of production.

And you reiterate that statement on—I believe—it is page 5.

> There are other significant differences between natural gas, oil, and coal markets, as I see it. The most obvious is that natural gas pipelines and local distribution companies are regulated by the Federal Government and by state governments.

And do you advocate deregulating pipelines and local public utilities?

Secretary HODEL. No, of course, Senator, we do not. In this proposal, I would suggest that the following analogy is more apt than might at first seem the case. Because in many, many instances, the sale of coal, particularly, is to regulated utilities. It is sold to somebody who, once they take it into their system, their whole operation from the cost of the operation of the powerplant through its transmission and distribution system is subject to regulation, either by FERC or the State, and in most cases both, if it crosses State lines.

Senator FORD. But you would get away from your free market theory and your free market argument when you do these things, in my opinion. None of us have a crystal ball. All of us have 20-20 hindsight.

Another obvious difference, as I see it, in the contracting practices is that natural gas is sold under long-term contract. Oil and coal both have a spot market. There is a spot market for oil, and a spot market for coal. There is no spot market for natural gas.

And do you advocate creating a natural gas spot market, and limiting a duration of a natural gas contract?

Secretary HODEL. Senator, I think that today, if this bill were in effect, there would be a spot market for natural gas. I think you would have producers, who are sitting on low-cost supplies unable to generate any cash flow, who would be eager to negotiate with industries presently shut down that cannot pay the current prices, in order to find a spot market, a temporary market.

To the extent of that excess pipeline capacity, it could well happen. The point is that today we do not permit it to happen, in effect because we have got a controlled, a rigid market. One of the things that we found in oil, and we find by not regulating coal, I think, is that that market goes out and looks for opportunities to sell that coal. The producer wants to sell it at the highest price possible, and the buyer wants to buy it at the lowest price possible.

We know that the net result of that ought to be, if they do their job well, approximately the right price.

Senator FORD. Just like the poor old farmer. He thinks it is what you give him. That is what happens to the coal industry. They go out, and you bid on their coal. And they can either take it or leave it. And some of them are fairly long contracts, escalation clauses for various and sundry things.

But I think you are mistaken. I do not know how you can get a spot market for natural gas. You are going to have to explain that one to me.

And I am going to have some written questions for the Secretary, Mr. Chairman. And I will move on to one other item.

Your statement says, and I will read from page 7:

> That as an incentive to renegotiate either party will be allowed beginning January 1, 1985 to opt out of any pre-enactment contract.

That may be your intent. But the bill is not drafted that way, in my opinion, and in those who have advised me. Because section 303, the market-out provision, applies only to "either party to a contract for the first sale of natural gas."

All right. Under the NGPA, first sales are sales for resale. Now first sales did not include direct industrial sales.

So what do you mean by that?

Secretary HODEL. I am advised, Senator, that the NGPA does not limit the definition of first sale to sales for resale, and that our language is drafted to carry out the intention.

I would be happy to supply an answer in detail on that, but I am satisfied this is what we intend to accomplish. If what we have drafted fails to do that, it ought to be corrected; and I appreciate having it pointed out to us. My draftsmen believe they have achieved what was intended, in conjunction with the definition that exists in NGPA.

Senator FORD. Well, I am just concerned about the old interstate gas—we are going to do a dual market here now, and you are moving right in that direction.

That was one of the things that we got rid of in 1977–78 that we hoped would continue—some of us now working when you have a bad winter.

Secretary HODEL. Senator, it is our hope that, if this were effective, as we believe it will be, in moving toward a free market, we will not have a dual market any longer; we will have a free market.

As of January 1, 1986, you have a not-controlled market in interstate, and, therefore, in intrastate you have the same. You now have a free market.

Senator FORD. We are going to have these, unless everyone is affected everywhere.

I was taught, Mr. Secretary, that it is nice to have faith, but faith without work is dead; and we are going to have to have a lot of work on this one.

The market out provision applies—because I want to follow through on my question—"applies only to either party to a contract for the first sale of natural gas."

What percentage of natural gas flowing in the United States would be subject to this provision?

Secretary **Hodel**. All except that in the intrastate market, and under our proposal, imports would not be included.

Senator **Ford**. Thank you for your answer, Mr. Secretary.

Do you intend to apply the sales between producers—do you intend it to apply to sales between producers and electric utilities?

Secretary **Hodel**. If it is a first sale, yes, it would, Senator.

Senator **Ford**. All right, now we are getting back to where they can go anywhere they want to.

Would it apply to producer reservation of offshore gas?

Secretary **Hodel**. We come back to the principle that, if it is the first sale, Senator, it would apply.

Senator **Ford**. Would it apply to sales or other transfers for value between pipelines and their affiliates and their subsidiaries?

Secretary **Hodel**. It should apply, but there is a further limitation, which prohibits the pipeline from taking at a higher rate from a high-cost affiliated contract than the highest rate of a lower cost nonaffiliated contract.

Senator **Ford**. Well, would a party invoking a market out provision have to give public notice or file a certificate with FERC that it had done so, so that others might be aware that the gas is available?

Secretary **Hodel**. There is no provision for that in the bill, Senator.

Senator **Ford**. Do you—one thing I am getting to—does market out protect the intrastate market?

Secretary **Hodel**. The market out provision doesn't apply to the intrastate market.

Excuse me, I stand corrected.

Senator **Ford**. Mr. Secretary, I believe your first answer is correct; and it is protected.

Secretary **Hodel**. My advice is that it was drafted to include intrastate contracts, as well as the market out.

Senator **Ford**. You've got two people behind you; one going this way, and the other one going this way. [Laughter.]

Secretary **Hodel**. I have heard, Senator, only from the one going this way. [Laughter.]

Senator **Ford**. And I was watching the other one. [Laughter.]

Secretary **Hodel**. One of us stands—obviously, we will have to——

Senator **Ford**. At least, we laughed. It has been tough all morning getting to that point.

Secretary **Hodel**. Thank you, Senator.

The **Chairman**. Senator Metzenbaum.

Senator **Metzenbaum**. Mr. Secretary, I am reasonably well convinced that the bill has a lot of merit because nobody seems to be for it. That would be rather persuasive that you have done a good job of alienating just about everybody. I suppose you probably can get unanimous vote for the bill on that basis.

But it is interesting you are indicating that the prices are going to come down 10 to 30 cents per thousand cubic feet. Now the people speaking for the consumers of the country—or at least, ostensibly speaking for them—don't think it will. George Lawrence, president of the American Gas Association, also doesn't think so.

He said that since this bill accelerates decontrol of old gas, we should be fearful that it is going to create upward price pressure. He has trouble seeing how it is going to result in lower prices.

I have also seen a report this morning—an unpublished report of the Energy Information Administration of your Department—indicating that prices will go up.

My question to you is: How can you come before us and be so certain that prices are going down 10 to 30 cents a thousand cubic feet? The industry says they are going to go up. I think the president of the Washington Power & Light Co. or some Washington-based company said they thought they would go up. Everyone seems to say they are going up.

Secretary **Hodel**. Senator, I don't think the people who are making those comments have looked at the operation of this bill as it is written.

Senator **Metzenbaum**. One is president of the American Gas Association.

Senator **Johnston**. He has interest, Howard.

Secretary **Hodel**. He has been very outspoken and very open with me and candid that he would never, could never support anything that would release the price of old gas.

He, I think, holds as an article of faith that it will have the effect which you perceive——

Senator **Metzenbaum**. As a matter of fact, Mr. Tankersly, Jack Tankersly, who was formerly president of the East Ohio Gas Co., a major operator in northern Ohio and a part of the Consolidated Natural Gas Co., said that decontrol would cost the American people $60 billion a year——

Secretary **Hodel**. Senator, excuse me, but——

Senator **Metzenbaum**. How can he say that while you are saying that decontrol will reduce prices?

Secretary **Hodel**. It is easy to say that. It would be true if what you are talking about is immediate decontrol with no other provisions involved, if you didn't deal with the contracts that exist—price escalation provisions.

Senator **Metzenbaum**. Let's forget about——

Secretary **Hodel**. We can't forget.

Senator **Metzenbaum**. In January 1986, this bill has total decontrol with no chance of reimposition.

Secretary **Hodel**. But this bill does not get to January 1, 1986, in an immediate decontrol mode, and this is where, I think, the analysts you have cited have gone off target.

The principles that are involved here indicate that we don't, first of all, decontrol price in the normal sense. We say the parties are free to negotiate, step one. They may negotiate. No matter what they negotiate for a period of time, we do control the price, either if they don't negotiate with the cap or if it is lower. If they do renegotiate, this restriction on pass through, which I think Senator Johnston correctly identifies, possibly is not going to operate at all during the time of this process.

Senator METZENBAUM. But the restriction on passthrough has an out, you can go to FERC; and FERC has those defenders of consumer that come from Louisiana and Texas.

Secretary HODEL. Senator, we really——

Senator METZENBAUM. How can you say that? That——

Secretary HODEL. That argument can't be carried in both directions at the same time. Either FERC will do as you fear, and that is just automatically pass this through without any delay——

Senator METZENBAUM. They have already indicated they are doing that. They have already indicated that by their decision.

Secretary HODEL. Senator, the decisions they make today are pursuant to the Natural Gas Policy Act which provides for that. This bill says you may not pass through until you have had a proceeding.

Now, that is a clearly different process than the one the Senator earlier has identified as a possible problem for those pipelines.

Therefore, let me complete this: I think if somebody analyzes the combination of the cap and the passthrough limitation and the existence of an excess gas supply out there, including low-price gas, which can't get to the market today, there is no way it can have that kind of effect. I think it is a simplistic response to say immediate decontrol would have the effect of a multimillion-dollar, billion-dollar runup.

That would be true if all the Congress did was just say: Let's decontrol price; "let's leave in place these contracts, with take-or-pay provisions and high prices established with indefinite price escalators and the like." That is not what we propose.

I don't think is fair to the people who are trying to understand this process to set that straw man up against our proposal. I think those who, outside this process, tried to do that are not helping the process.

Senator METZENBAUM. Well, let me go to another source then. You don't accept the American Gas Association; you don't accept the Washington Power & Light; you don't accept Mr. Tankersly, head of East Oil Gas. Let me give you another one.

Reading from a newspaper, the Washington Post:

> President Reagan's proposal for removing Federal controls from the price of natural gas would produce one certain winner, a major oil company. The top 20 producers of such gas, led by Mobil, Exxon, Texaco, Gulf, and Shell, control more than 70 percent of it, stand to gain a $40 billion windfall between now and 1990 if controls are lifted, according to industry analysts.

Are they just dreaming?

Secretary HODEL. Does it name the industry analyst, Senator?

Senator METZENBAUM. I don't know, but I would guess that—you know, I usually accept what newspapers say, if they——

[Laughter.]

Senator METZENBAUM. Let me finish—particularly, if they agree with me. [Laughter.]

Secretary HODEL. I must confess I was very pleased with a couple of editorials, one from that paper and one from the New York Times, and I guess I follow the same process; it shouldn't be too critical.

Senator METZENBAUM. That is right.

Here is a paper that editorially is on your side, so I think it is fair to say that they would insist that their reporters get some balance——

[Laughter.]

Secretary **Hodel**. Laying aside that portion of the issue, I think we need to look at from whence that kind of analysis comes, first of all. We all have different perspectives on this issue, depending on where our interests are, no doubt.

But the whole issue of this windfall question is an interesting one to me because, if we do what we are talking about, there will be winners and losers over here on the production side. In fact, that is why there is going to be such intensity of debate and discussion coming from those who see themselves as big winners or big losers.

But, what we are trying to accomplish, I believe, is an adequate supply at a reasonable price to the consumer. I think what we have to focus on is making sure the provisions we put in place here will protect the consumer, and then we need to let that market operate. That will be very unsatisfactory to some of those with high-priced contracts today who do not have a market for that gas.

Senator **Metzenbaum**. Mr. Hodel, you had indicated that one of the major reasons for prices that have shot up so rapidly in the last couple of years had to do with a pass through decision. Is that correct?

Secretary **Hodel**. Yes.

Senator **Metzenbaum**. I think you said that.

Secretary **Hodel**. Yes, it is a combination of the fact that the passthrough, as it now operates, does not provide an incentive to pipelines to be really tough in the negotiation of price.

And, second, price has tended to follow the NGPA levels.

Senator **Metzenbaum**. All right.

Secretary **Hodel**. In other words, they become floors as well as ceilings.

Senator **Metzenbaum**. All right.

Now, then, you have also indicated that your lawyers have told you that you can vitiate the effectiveness of those take-or-pay contracts.

And you have proposed to limit take or pay to 70 percent. According to your legal counsel, any number is legal. Would it not then help to solve the total problem of increased costs upon the consumers, assuming we don't pass this legislation, if we pass legislation in the Congress which would totally void or vitiate all take-or-pay contracts?

If we can do it for 30 percent, we can do it for 100.

Secretary **Hodel**. Let's analyze what the effect will be. If you didn't terminate those contracts, or permit them——

Senator **Metzenbaum**. Permit them——

Secretary **Hodel** [continuing]. If you follow the two ways to approach it—one is to just say, "They are through."

The other one is to say: "At the option of the purchaser, they are through or reduced."

Senator **Metzenbaum**. OK.

Secretary **Hodel**. Let's say we took the second approach.

What is the effect under the present situation? The pipelines clearly have to have additional supply over time. They are going to sit right back down to negotiate supply contracts with producers, and they may stay away because of having been burnt on these take-or-pay provisions. But today they still don't have that incentive to look for and demand the least cost gas.

There is a desire to, and I don't mean to suggest—and I have to emphasize this—that I think they negotiate in bad faith. I don't mean that at all. The fact is, however, when two people sit down to negotiate and they know the rules of the game are skewed in one direction—if it strengthens the one and weakens the other——

Senator **Metzenbaum**. It would be legal for them to renegotiate.

Secretary **Hodel**. They could sit right back down and renegotiate——

Senator **Metzenbaum**. Today without any change in the law.

Secretary **Hodel**. One of the problems in renegotiations today, Senator, is there are all kinds of additional dependent interests. For a producer, who has either stockholders or royalty holders, to sit down and willingly, with no necessity for doing so, negotiate a lower price, that producer does run the risk the royalty holders or stockholders will come back with a lawsuit which says you have given away price.

Senator **Metzenbaum**. That is the same situation under your bill.

Secretary **Hodel**. I would beg to differ on the grounds that under our bill there is not only a price cap during the nonnew contract period, but thee is the right to abrogate on the part of the pipeline so that that producer would be able to say to his royalty holders, "Look, the situation I was in was, that I knew that on January 1, 1985, he could terminate the contract, abrogate it. Because of that, I thought it clearly was preferable to negotiate a new lower price to maintain my cash flow and meet my debt service obligations."

Senator **Metzenbaum**. Mr. Hodel. the thrust of your bill, as I see it, is that it can give the pipelines the opportunity to renegotiate, that you can count on them to bring down prices, and they will not pass it through by reason of the limitations in the bill; and therefore we should count on them to negotiate—renegotiate their contracts downward, and that that would help the consumer.

Secretary **Hodel**. Senator, if——

Senator **Metzenbaum**. Pipelines have not given any evidence of being the least bit concerned about consumers today. Why should we expect to rely upon them tomorrow?

Secretary **Hodel**. Right. Senator, you are so close to stating my position correctly that I almost hesitate to modify the statement. [Laughter.]

But I——

Senator **Metzenbaum**. I didn't even write the editorial.

Secretary **Hodel**. I feel constrained to make one adjustment in what you have said. I agree with what you have said; they have not shown the concern to date to be protective of the consumer.

But, the jeopardy in which they would find themselves if they fail to do it under this bill, which was identified by Senator Johnston in his question with regard to the difficulty and delay in passthrough, that jeopardy is so significant that it changes the whole atmosphere in which they have to approach the negotiating table.

And, it would convert them, which is what—somehow, we have to get to the point, Senator, where somebody in that negotiation process is concerned about the consumer. And there is no way to get the low-cost gas to market unless that process takes place.

The **CHAIRMAN**. Senator Metzenbaum, I know you want the last word, but in this round, the Secretary has the last word.

Senator **METZENBAUM**. I have no problem with that.

The **CHAIRMAN**. I know ultimately you will have the last word. [Laughter.]

Senator **METZENBAUM**. He can't get on the Senate floor, can he?

The **CHAIRMAN**. No. No.

But on this round, he is entitled to it.

Senator **HEINZ**. It is not necessarily the last, but you missed the boat.

The **CHAIRMAN**. Senator Nickles.

Senator **NICKLES**. Thank you, Mr. Chairman.

Mr. Secretary, again, I will compliment you for the astuteness which you have not only learned this subject and had a good grasp on it, but the way that you have presented it before the committee.

I will ask you a general question. Is there any other product, any other resource in the United States that the Federal Government controls the price?

Secretary **HODEL**. Well, electricity.

Senator **NICKLES**. We have a Federal price level on what the city of Ponca City, Okla., can——

Secretary **HODEL**. No.

Senator **NICKLES** [continuing]. Produce electricity at?

Secretary **HODEL**. In most cases, electricity prices are controlled by the State public utility commission, or, in the case of public power, by the municipality or the public body.

Senator **NICKLES**. Well, wouldn't it be the case that almost all utilities, in each State, or region, has their own public utility corporation, commission, whatever you want to call it, that regulates their utilities including phones and gas and electricity, et cetera, in their communities, and you are not proposing to abolish any of that as maybe we have talked about.

You are talking about getting the Federal regulation, and actually I believe that you will find that natural gas is the only commodity that the Federal Government has regulated, and quite frankly, I think the Federal Government has done quite a poor job over the last several years, and that has really been responsive, or responsible for a lot of the problems that we have.

We only have one segment of natural gas that is deregulated. That is the 107 gas. Can you tell us what has happened to 107 gas prices, in let's say, the last year?

Secretary **HODEL**. In the last year, they have fallen; but until then, as you know, they rose, and I would like to comment on one reason why this occurred.

A lot of comment has been made about the importance of the low-cost gas cushion. That cushion permitted pipelines with a large cushion of low-cost gas to go out and pay—and agree to pay—very high prices for new gas coming into the system, because they had this ability to average it down. Quite clearly, those prices that we showed on the chart, going from up to the $10 and $11 range, were clearly too high.

Now, what has happened is that, in some cases, there has been a willingness to renegotiate on the part of the producers. How widespread that is, nobody can really say; second, there have been a couple of instances in which pipelines simply announced they will not continue to take at the required levels because the prices are too high.

They just plain said, "We can't market at that level," and they de facto marketed out.

Senator NICKLES. I think that is a good point to make, and I think others on this committee should know that the low artificially held prices on old gas and other gas has subsidized the old gas or the new gas, and the only decontrolled gas.

But also, it should be pointed out that since that is the only category of natural gas that is really decontrolled if you really wanted to know, it has dropped substantially, and I have talked to some producers in Oklahoma, who were in the process of signing new contracts for deep gas.

One told me that he signed a contract for $3.30, and was glad to get the price, and so, the floor is fallen through, and the chart shows a very high price for 107 and those were on the initial contracts, and I think you will find, if you could and possibly maybe advise this committee, and show the committee what new prices on 107, because that is deregulated gas, and I think you will find it substantially less than what most anyone in this room would probably recognize.

The bottom is falling out of that market. That is the reason why we are running 32 percent of the rigs in Oklahoma. NGPA created this incentive to go out and get it and the marketplace has done it; they have produced it, and the prices have fallen substantially.

I think that is extremely important because the only area that is deregulated, the prices have fallen. In all other cases where you have NGPA, which has set the ceiling, has actually become the floor, and actually encouraged the price increases.

But the only case where you have deregulated gas, you see the price falling in the last year, and it is a substantial fall, not a small reduction of 5 or 10 percent, but very, very significant, substantial reduction.

A couple of questions that I might bring up, and will try to bring up fairly rapidly, I guess, on the gas cap; and I touched on it earlier in my statement.

Do you envision the gas cap at being a market price—market clearing price for natural gas?

Secretary HODEL. We envision that, but whether it will operate that way remains to be seen. One of the questions that was raised earlier is a valid question, and that is—if you have a limited number of contracts, which include renegotiated and new contracts, and if low-cost gas only moves part way, you could end up with an arbitrarily low-average gas cap which would have a very sharp downward pressure on the rest of the gas.

Senator NICKLES. I very much concur with that, because I think when you average in those low contracts that have been renegotiated, if they are 40 or 50 cents, and they go to a dollar, that is not market price for gas.

Conversely, you have a $10 price for 107 and it is renegotiated, and it has renegotiated at $8. That is not market price for gas either.

So, I would encourage you in the administration to consider possibly altering your proposal where it includes new natural gas contracts. Maybe, extend the time base over which that is computed so you wouldn't have a very small number of contracts.

But I don't really know that renegotiated contracts on old or deep gas either one would be market price, and both of which may give you too much of a cyclical change in the cap; and if you left it like—I mention that because I would hope that you would go to new gas as your new gas cap.

Another reason why I mention that, if you do leave it as is, and you have a large degree, and no one knows—and I think you have stated that. No one knows how many of the old contracts to be renegotiated in this period.

If you had a significant number of old gas contracts that were renegotiated at less than market, which I would think that would be a fact, then you would have a gas cap that would come in quite a bit less than marketplace, and you are telling a producer, or say that just signed a contract this year for $3.30, and if it came in at $2.50, you could be sending him into bankruptcy.

It could be quite possible that he has gone to the bank and he has leveraged that production, to pay for his rig, to pay for additional drilling, et cetera, and if you just pull the rug out from underneath him, and say, "We are sorry, Mr. Producer. Yes, we know you signed a contract for $3.30; we realize—yes, we came up with this new gas cap formula, and we are sorry that it came out $2.50; but you just lost 70 or 80 cents"; and that happened to be the point that would push him over the brink.

I am very, very concerned about that, and as I see the definition of gas cap, I could see that happening.

Secretary HODEL. Senator, that is a possibility, under the proposal. As you may guess, we did not draft that provision lightly. We did consider the alternatives, and decided that we would make the proposal in this form. Part of the consideration was, and I am not suggesting again that we are just totally locked into any of these provisions, but what we thought was important about that was exactly the point you are making: There would be, in a situation you postulate, a very strong incentive for that producer to sit down, discuss and negotiate with the pipeline a new contract because under the new contract he is entitled to charge whatever price they agree upon. The pipeline would have a tendency to want to drive the price down, but they might be able to negotiate a provision which allowed sufficient cash flow to keep the producer in business and still help leaven the price impact for the pipeline.

There is an incentive there, the way it is drafted. I am aware of the problem, and I am sure it is one we will continue to analyze and consider.

Senator NICKLES. Well, I think it is one that we certainly need to work on. Senator Metzenbaum, I wish he was here, because he was talking about, "hey, the pipelines are going to come up on the short end of the stick."

I could see this, where they could come up with a lot of room, you know, to make some other price increases in some other areas.

There is so much to talk about and so little time. I have a hard time, of course, with the abrogation of the contract—a very, very difficult time.

Could you provide us—you said that you had a legal analysis—could you provide for the committee the rationale behind that, not necessarily at this time, but I seriously question this, just how much—you know, when you have the sanctity of contracts, a lot of us believe quite strongly in where we decide yes, we could do that; and I would almost concur if this committee determines it is easily enough said to roll back and take or pay at 70 percent, then there is nothing magic and that could be switched to 0 or 50 or anything else, or any contract could be abrogated, we say January 1, 1985—one party out, that could be changed tomorrow.

So, I wrestle with that problem; and also I question the necessity of it, because here again new contracts are leaving market out. New contracts are taking take or pay at a fixed percentage, and at these tremendous rates today, so I think the marketplace is almost getting around to some of those previous contracts that were very high and very much out of the marketplace. I think the new contracts were taking care of that.

The marketplace may settle that problem without us legislatively interfering in it.

Secretary HODEL. Senator, we didn't approach the contract question lightly or casually either; nor did the President, and I do have, and I would submit for the record, Mr. Chairman, with your permission, a memorandum on this question, from our General Counsel, which may be of interest to you, Senator.

Senator NICKLES. I appreciate that.

Secretary HODEL. Ultimately, our problem, assuming we have the legal authority to do what we say we can do was what about the philosophical and policy question that is involved in dealing with these contracts?

It was not lightly arrived at, but we did conclude, ultimately, that in order to have a viable package we had to do something about those contract provisions.

The CHAIRMAN. Did I understand, Mr. Secretary, that you have a legal opinion that you will submit at this time?

Secretary HODEL. Yes, sir.

The CHAIRMAN. It will be made a part of the record.

Secretary HODEL. Thank you.

[A copy of the memorandum dated March 8, 1983, from the Acting General Counsel for the Department of Energy to Secretary Hodel on the constitutionality of Federal natural gas legislation modifying private sales contracts follows:]

Department of Energy
Washington, D.C. 20585

March 8, 1983

MEMORANDUM FOR: The Secretary

FROM: Acting General Counsel

SUBJECT: Constitutionality of Federal Natural Gas Legislation Modifying Private Sales Contracts

You have requested my opinion as to whether the Congress has the constitutional power, by legislation, to authorize unilateral alteration of existing contractual relationships among segments of the natural gas industry. For the reasons stated more fully in the attached memorandum, I have concluded that the Congress, without question, has that power.

The constitutional source of this power is Article I, §8, which grants to the Congress the power to "regulate Commerce with foreign Nations, and among the several States...." The court cases examining the relationship between federal regulatory activities and private contracts uniformly have held that, in effect, the terms of private contracts must yield to a constitutionally-permissible regulatory scheme adopted by the Congress. The permissible ambit of Congress' power to regulate interstate commerce, as defined in Supreme Court decisions over many years, is extremely broad. Though Article I, §10 of the Constitution provides that "No State shall ... pass any ... law impairing the obligation of contracts," this restriction is not applicable to the Federal Government. Even as to the states it is not applied with "literal exactness." Home Bldg. & Loan Assn. v. Blaisdell, 290 U.S. 398, 428 (1934).

The existence of this power does not make appropriate its indiscriminate application. The Department's original antipathy to its broad exercise is quite understandable. As to these contracts, however, I understand that in developing its proposal the Department was confronted, time and again, with their provisions in seeking ways to relieve natural gas consumers from bearing the entirety of the economic risk associated with transition to a decontrolled natural gas market.

Many of these contract terms, I understand, together with a pattern of reliance on significant volumes of expensive gas, were directly traceable to prior dislocations in the natural gas market which themselves are atributable to controls under the Natural Gas Act and Natural Gas Policy Act. In these circumstances it seems not only constitutionally appropriate but almost inevitable that any legislation that would provide a workable transition from detailed and complex regulation of the natural gas market would have to address, either expressly or by its necessary effect, commercial relationships established under the prior regulatory regime.

Eric J. Fygi

Attachment

March 8, 1983

CONSTITUTIONALITY OF FEDERAL NATURAL GAS LEGISLATION MODIFYING PRIVATE SALES CONTRACTS

I. Summary

Congress clearly has the constitutional authority to modify and otherwise affect existing contracts for the sale of natural gas. On the basis of its power under the Commerce Clause, Congress has declared unenforceable or modified certain clauses in natural gas contracts and has authorized the Federal Energy Regulatory Commission (Commission) and its predecessor, the Federal Power Commission, to modify natural gas contracts. It is well settled that the sale of commodities, such as natural gas, traded in interstate commerce or whose trade substantially affects interstate commerce, is within Congress' power under the Commerce Clause and that Congress may pass laws to prohibit or restrict such trade in any manner, including laws that restrict the price and terms on which the commodities are sold. There is no constitutional prohibition against exercising its power to modify contracts. The Impairment Of Contracts Clause only applies to the States. Congress has plenary power under the Commerce Clause unless the exercise of this power violates an express constitutional limitation. Only under extraordinary circumstances, not present in the Natural Gas Consumer Regulatory Reform Amendments of 1983, would other sections of the Constitution limit Congress' power under the Commerce Clause.

II. Discussion

A. Power of Congress Under the Commerce Clause

Article I, §8 of the Constitution grants to Congress the power to "regulate Commerce with foreign Nations, and among the several States...." Numerous decisions of the Supreme Court have confirmed the breadth of this legislative power and the discretion it vests in Congress to pass laws governing interstate commerce and the terms and conditions under which private persons may participate in such commerce. The leading case is Gibbons v. Ogden, 22 U.S. 1 (1824) (the supremacy of the power of Congress under Article I, §8 to license ships employed in the coastal trade upheld over a conflicting state statute), in which Chief Justice Marshall described the nature and extent of Congress' power under the Commerce Clause as follows:

> We are now arrived at the inquiry, What is this power?
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> It is the power to regulate; that is, to prescribe the rule by which commerce is to be governed. This power, like all others vested in Congress, is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution. These are expressed in plain terms, and do not affect the questions which arise in this case, or which have been discussed at the bar. If, as has always been understood, the sovereignty of Congress, though limited to specified objects, is plenary as to those objects, the power over commerce with foreign nations, and among the several States, is vested in Congress as absolutely as it would be in a single government, having in its constitution the same restrictions on the exercise of the power as are found in the constitution of the United States. The wisdom and the discretion of Congress, their identity with the people, and the influence which their constituents possess at election, are, in this,

> as in many other instances, as that, for example, of declaring war, the sole restraints on which they have relied, to secure them from its abuse. They are the restraints on which the people must often rely solely, in all representative governments....
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> 22 U.S. at 196-197 (emphasis added).

In NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937) (the constitutionality of the National Labor Relations Act of 1935 affirmed), Chief Justice Hughes described the reach of Congress' power under the Commerce Clause as follows:

> The fundamental principle is that the [congressional] power to regulate commerce is the power to enact "all appropriate legislation" for "its protection and advancement;" to adopt measures "to promote its growth and insure its safety;" "to foster, protect, control and restrain."
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> 301 U.S. at 36-37 (citations omitted).[1]

In a more recent case, the Court concluded:

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[1] The extreme reach of the Commerce Clause can be seen in Wickard v. Filburn, 317 U.S. 111 (1942), in which the Court upheld federal marketing quotas applicable to wheat consumed on the farm on which it was raised. See also U.S. v. Darby, 312 U.S. 100 (1941), in which the Court upheld The Fair Labor Standards Act of 1938 and held that Congress may regulate any "activities intrastate which have a substantial effect on the [interstate] commerce or the exercise of Congressional power over it." Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 281 (1940) (federal agency may establish maximum and minimum prices for coal); U.S. v. Carolene Products Co., 304 U.S. 144 (1938) (Congress may prohibit the sale of imitation milk); Texas & N.O.R. Co. v. Railway Clerks, 281 U.S. 548 (1930) (railroads may not interfere with employees' formation of a union); Highland v. Russell Car Co., 279 U.S. 253 (1929) (federal government may override an apparent contract and dictate the price of coal); Philadelphia, B & W R.R. Co. v. Schubert, 224 U.S. 603 (1912) (carriers are liable for employees' injuries despite contracts limiting such liability); Baltimore & O.R.R. Co. v. I.C.C., 221 U.S. 612 (1911) (hours of labor on railroad limited); Patterson v. Bark Endora, 190 U.S. 169 (1903) (advances of wages to seamen prohibited); Addystone Pipe & Steel Co. v. U.S., 175 U.S. 211 (1899) (federal antitrust laws upheld).

> The power of Congress in this field [of interstate commerce] is broad and sweeping; where it keeps within its sphere and violates no express constitutional limitation it has been the rule of this Court, going back almost to the founding days of the Republic, not to interfere. 379 U.S. at 305. [2/]

The foregoing cases support the power of Congress to enact legislation regulating natural gas in interstate commerce, including any and all contractual terms and conditions of its sale. As these cases state, this power is plenary unless there is an express constitutional limitation against the action taken by Congress. There is no constitutional prohibition against the impairment of contracts by Congress. The prohibition against passage of any "Law impairing the Obligation of Contracts" in Article I, §10 only applies to the states.[3/]

Indeed, in the so-called "Gold Clause Cases," the Court put to rest any notion that preexisting private contracts could limit Congress' power to legislate under the Commerce Clause. Norman v. B. & O. R. Co., 294 U.S. 240 (1935). The Court held

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[2/] E.g., Katzenbach v. McClung, 379 U.S. 294, at 305 (1964) (Civil Rights Act of 1964, Title II, held constitutional; court will ordinarily defer to a congressional determination that an activity substantially affects interstate commerce); Heart of Altanta Motel v. U.S., 379 U.S. 241 (1964) (companion case to Katzenbach v. McClung); Maryland v. Wirtz, 392 U.S. 183 (1968) (extension of Fair Labor Standards Act to cover employees of schools and hospitals, including those operated by states, held constitutional).

[3/] Other constitutional provisions that may appear to limit economic regulation do not apply to the proposed federal legislation under consideration here. The prohibition against passage of any "ex post facto Law" in Article I, §9 applies only to penal criminal statutes. Calder v. Bull, 3 U.S. 386 (1798).

that Congress could expressly invalidate provisions in private bonds (including those of states and their subdivisions) calling for payment in gold or gold coin and direct that such payment be made exclusively in legal tender, which had been devalued in reference to the "free market" price of gold. Holders of various bonds issued by private companies had demanded payment in gold coin, asserting that the federal law prohibiting such payment contravened the Due Process Clause of the Fifth Amendment, which these holders asserted prevented Congress from impairing the obligations of these contracts. 294 U.S. at 246-47. They argued that Congress lacks the power directly to enlarge or diminish an obligation. Id. at 243. The Court dismissed these arguments, stating:

> [T]he point is pressed that [the] express stipulations for gold payments constitute property.... [T]he contestants urge that the Congress is seeking not to regulate the currency, but to regulate contracts, and thus has stepped beyond the power conferred.
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> This argument is in the teeth of another established principle. Contracts, however express, cannot fetter the constitutional authority of the Congress. Contracts may create rights of property, but when contracts deal with a subject matter which lies within the control of the Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them.
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> ....
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> The principle is not limited to the incidental effect of the exercise by the Congress of its constitutional authority. There is no constitutional ground for denying to the Congress the power expressly to prohibit and invalidate contracts although previously made, and valid when made, when they interfere with the carrying out of the policy it is free to adopt.
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> 294 U.S. at 307-10.

The subsequent sections of this memorandum explore the possibility that a limitation is imposed by the Due Process Clause or the Takings Clause of the Fifth Amendment, or by the Tenth Amendment. The final section discusses prior regulation of natural gas contracts under the Commerce Clause.

B. Substantive Due Process

The Fifth Amendment to the U.S. Constitution directs that under federal law no person shall "be deprived of life, liberty, or property, without due process of law...." For many years the Due Process Clause of the Fifth Amendment was the primary constitutional provision argued as a barrier to the constitutionality of federal economic legislation under the Commerce Clause. These arguments were based on a doctrine called substantive due process.

Substantive due process was first used to invalidate economic legislation in Allgeyer v. Louisiana, 165 U.S. 578 (1897) (Louisiana law prohibiting any act to effect insurance on property in Louisiana issued by any company not admitted to do business in the state held a violation of the Due Process Clause of the Fourteenth Amendment). The Court stated that the Due Process Clause[4/] guaranteed the liberty of a person "to enter into all contracts which may be proper,

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[4/] The Fourteenth Amendment contains a Due Process Clause applicable to the States which is essentially the same as the Due Process Clause of the Fifth Amendment. The doctrine of substantive due process treated both Due Process Clauses alike.

necessary, and essential" to his livelihood or avocation. 165 U.S. at 589. Until 1937 all federal and state economic legislation ran the risk of being held by the courts to violate the substantive due process standards of the Constitution. Disregarding strong dissents, the Court read into the due process clauses a guarantee of a liberty of contract which the federal government or a state could not abridge unless it could show that the economic regulation served a public interest lying within the government's power to protect.[5/] In other words, the due process clauses generally preserved a laissez faire economic system, placing certain economic activities beyond the reach of any governmental regulation.

Despite the denial of the justices sustaining substantive due process challenges, it was clear that this doctrine forced the courts to evaluate the wisdom of the economic policies adopted by Congress or the state legislatures and to sit in judgment as a super-legislature. The explosion of federal economic regulation in response to the Great Depression eventually forced the Supreme Court to reformulate its theory of substantive due process as a guardian of economic rights. In Nebbia v. New York, 291 U.S. 502 (1934), the

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[5/] E.g., Adkins v. Children's Hospital, 261 U.S. 525 (1923) (federal law establishing agency to fix minimum wages for female employees in D.C. held invalid); Adair v. U.S., 208 U.S. 161 (1908) (federal law prohibiting railroads from firing an employee for membership in a union held invalid); Lochner v. New York, 198 U.S. 45 (1905) (state law fixing maximum working hours for bakers held invalid).

Court upheld against a due process challenge a state law establishing an agency to set maximum and minimum prices for milk. The Court stated that, as appropriate, states could regulate businesses in any aspect even if the businesses were not public utilities, common carriers or affected with an extraordinary public interest. The Court emphasized the discretion the legislature had in such cases was not subject to reevaluation by the judiciary under the due process clauses:

> So far as the requirement of due process is concerned, and in the absence of other constitutional restriction, a state is free to adopt whatever economic policy many reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose. The courts are without authority either to declare such policy, or, when it is declared by the legislature, to override it. If the laws passed are seen to have a reasonable relation to a proper legislative purpose and are neither arbitrary nor discriminatory, the requirements of due process are satisfied, and judicial determination to that effect renders a court _functus_ _officio_....
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> ....
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> The Constitution does not secure to any one liberty to conduct his business in such fashion as to inflict injury upon the public at large, or upon any substantial group of the people. Price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty. 291 U.S. at 537-39.

The Supreme Court overruled earlier cases that marked the apex of the protection of economic rights by substantive due process.[6] More recent cases have confirmed the practical disappearance of substantive due process. In *Duke Power Co. v. Carolina Environmental Study Group*, 438 U.S. 59 (1978), the Court upheld the federal Price-Anderson Act, limiting liability in case of a nuclear power plant accident, against a substantive due process attack. The Court noted the strong "presumption of constitutionality" of economic regulations, for which the Court defers "to the Congressional judgment unless it is demonstrably arbitrary or irrational." 438 U.S. at 83-84. The Court examined this judgment as reflected in the legislative history and found that the judgment had an apparently reasonable basis. In *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117 (1978), the Court noted that the appellants' "substantive due process argument requires little discussion." The Court concluded that "this argument rests simply on an evaluation of the economic wisdom of the [state] statute" and does not limit the legislature's power, regardless of the "ultimate economic efficacy of the statute," which forced major refiners to divest themselves of ownership and operation of retail outlets for the sale of motor gasoline in the state. 437 U.S. at 125-26. The Court was content to rest its determination of the law's rationality on a one-sentence recitation of its purpose. In Ferguson v. Skrupa, 372 U.S. 726 (1963), the Court upheld a state law and reversed a district court judgment finding a Kansas statute, restricting the business of debt collection to attorneys, in violation of the Due Process Clause of the Fourteenth Amendment. The lower court had mistakenly relied on a substantive due process case, Adams v. Tanner, 244 U.S. 590 (1917), that like the other such cases listed above is no longer good law. The Court emphasized:

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[6] *E.g.*, *Adkins v. Children's Hospital*, expressly overruled by *West Coast Hotel Co. v. Parrish*, 300 U.S. 379 (1937) (state minimum wage law valid); *Adair v. U.S.*, overruled in substance by *Phelps Dodge Corp. v. N.L.R.B.*, 313 U.S. 177 (1941) (federal law may prohibit an interstate carrier from firing an employee for union activity); *Lochner v. New York*, overruled *sub silentio* by *Bunting v. Oregon*, 243 U.S. 426 (1916) (state law may fix maximum hours for most industrial workers).

> Under the system of government created by our Constitution, it is up to legislatures, not courts, to decide on the wisdom and utility of legislation. There was a time when the Due Process Clause was used by this Court to strike down laws which were thought unreasonable, that is, unwise or incompatible with some particular economic or social philosophy....
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> ....
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> The doctrine that prevailed in [these substantive due process] cases... has long since been discarded. We have returned to the original constitutional proposition that courts do not substitute their social and economic beliefs for the judgment of legislative bodies who are elected to pass laws.... Legislative bodies have broad scope to experiment with economic problems....
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> ....
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> Whether the legislature takes for its textbook Adam Smith, Herbert Spencer, Lord Keynes, or some other is of no concern of ours.

372 U.S. at 729.

C. Equal Protection Under the Due Process Clause

The Due Process Clause of the Fifth Amendment imposes an equal protection obligation on the Federal Government similar to the equal protection obligation imposed on the states by the Fourteenth Amendment. With the rejection of substantive due process as a limit on economic regulation, recent constitutional challenges to such regulation have emphasized equal protection arguments. The Supreme Court, however, has been as unwilling to invalidate economic legislation on the basis of equal protection as on the basis of substantive due process, recognizing that to do so on either basis would embroil the Court in the legislative process.[7/]

Any equal protection challenge has a heavy burden to overcome since "[s]ocial and economic legislation . . . that does not employ suspect classifications or infringe on fundamental rights must be upheld against equal protection attack when the legislative means are rationally related to a legitimate governmental purpose." Hodel v. Indiana, 452

[7/] E.g., Schweiker v. Wilson, 450 U.S. 221 (1980) (upheld against equal protection attack refusal of federal government to provide Supplemental Security Income benefits to inmates of public mental institutions that do not receive Medicaid funds); U.S. Railroad Retirement Board v. Fritz, 449 U.S. 166, 174-179 (1980) (rejected argument that Congress violated equal protection when it restructured railroad retirement in a manner that preserved dual retirement benefits for some employees but not others); Jefferson v. Hackney, 406 U.S. 535 (1972) (state can provide lower welfare benefits to recipients of Aid to Families with Dependent Children than to the sick and elderly).

U.S. 314, 331 (1981) (Congress acted rationally to allow variances for mining operations on steep slopes and mountaintops but not on prime farmlands). The magnitude of this burden can be gauged by the tenor of the Court's language in Vance v. Bradley, 440 U.S. 93 (1979), where it upheld mandatory retirement for Foreign Service employees at age 60, even though no mandatory retirement age is established for Civil Service employees, including those who serve abroad. The Court stated:

> "The Constitution presumes that, absent some reason to infer antipathy, even improvident decisions will eventually be rectified by the democratic process and that judicial intervention is generally unwarranted no matter how unwisely we may think a political branch has acted. Thus, we will not overturn such a statute unless the varying treatment of different groups or persons is so unrelated to the achievement of any combination of legitimate purposes that we can only conclude that the legislature's actions were irrational." Id. at 97. 8/

The Court will not second-guess Congress where there is a conceivable basis for the classification adopted by Congress, especially if it explains this basis. Accordingly, an

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8/ See also Metropolis Theatre Co. v. City of Chicago, 228 U.S. 61, (1912) (classification of theatres for license fees based on price of admission upheld even though some theatres with higher admission prices actually had lower earnings on the basis that "[t]he problems of government are practical ones and may justify, if they do not require, rough accommodations - [however] illogical, it may be, and unscientific"); Lindsley v. National Carbonic Gas Co., 220 U.S. 61, 78-79 (1911) (state may regulate the pumping of mineral springs differently on the basis of whether the water is pumped for resale or for other purposes as long as "any state of facts reasonably can be conceived that would sustain" the classification).

equal protection challenge to the Natural Gas Consumer Regulatory Reform Amendments would not succeed.

D. The Takings Clause

The Takings Clause of the Fifth Amendment provides that private property shall not be taken for public use without just compensation. Although the Supreme Court has recognized that economic regulations can limit and even destroy the value of private property, it has been most reluctant to find that such regulations constitute takings for which the government must pay compensation:

> "To require compensation in all such circumstances would effectively compel the government to regulate by purchase. Government hardly could go on if to some extent values incident to property could not be diminished without paying for every such change in the general law.
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> ....
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> The Takings Clause, therefore, preserves governmental power to regulate, subject only to the dictates of justice and fairness.'" Andrus v. Allard, 444 U.S. 51, 65 (1979) (citations omitted).

In many instances, the Court has dismissed "taking" challenges on the ground that, while the challenged government action caused economic harm, it did not interfere with interests that were sufficiently bound up with the reasonable expectations of the claimant to constitute "property" for Fifth Amendment purposes.[9/] In assessing claims for damages

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[9/] E.g., Regional Rail Reorganization Cases, 419 U.S. 102, 125-136 (1974) (non-contractual retirement right is not property); United States v. Willow River Power Co., 324 U.S. 499 (1945) (interest in level of river to maintain power head is not property); United States v. Chandler-Dunbar Water Power Co., 229 U.S. 53 (1913) (no property interest can exist in navigable waters).

based on alleged takings, the Court traditionally has found the diminution of anticipated profits less compelling than the reduction of the value of other property-related interests as a basis for finding a taking of property. The Court observed in Andrus v. Allard that the "loss of future profits--unaccompanied by any physical property restriction--provides a slender reed upon which to rest a takings claim." 444 U.S. at 66.

The Court has found there is no taking even in situations where a governmental regulation has caused substantial harm to property interests so long as the regulation serves a substantial public interest. E.g., United States v. Central Eureka Mining Company, 357 U.S. 155 (1958). In that case, the federal government ordered the closing of gold mines to assist the war effort by encouraging the reallocation of scarce manpower and equipment resources from unessential to essential mining operations. In finding that this action did not constitute a taking, the Court emphasized that the order was "a well-considered decision to accomplish a proper result." Id. at 167.[10/] The Court has been especially

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[10/] See also Goldblatt v. Hemstead 369 U.S. 590 (1962) (city ordinance that bans excavation below water table is not a taking even though it effectively prohibits continued operation of long-established sand and gravel mining business); Atchison, T. S.F. R. Co. v. Public Utilities Commission, 346 U.S. 346 (1953) (railroad need not be compensated for requirement that it share cost of constructing railroad grade improvement); U.S. v. Caltex, 344 U.S. 149 (1952) (deliberate destruction by the federal government of oil facilities in time of war not a taking); Miller v. Schoene, 276 U.S. 272 (1928) (state order to remove ornamental cedar trees that endanger apple orchards not a taking).

reluctant to find a taking when the interference "arises from some public program adjusting the benefits and burdens of economic life to promote the common good" and "can[not] be characterized as a physical invasion by the government."[11/]

The Natural Gas Consumer Regulatory Reform Amendments would affect natural gas contracts and the industry generally in order to remedy perceived defects in existing legislation and thereby protect consumers. None of its provisions would compel any physical surrender of property to the government for its use. It is clear, therefore, that it would not directly appropriate or take private property for public use without just compensation. In fact, it would leave individuals free to dispose of their natural gas and to carry on their businesses in any manner consistent with the law and even would permit the readoption of the affected contractual provisions.

[11/] Penn Central Transportation Co. v. New York City, 438 U.S. 104, 124 (1978) (historical preservation law that prohibited construction of building above Grand Central Station upheld). See generally Hodel v. Virginia Surface Mining and Reclamation Association, 452 U.S. 204, 295-296, (1981) (law regulating the conditions under which surface mining may be conducted upheld); Andrus v. Allard, supra, at 65-66 (law that bars the sale of artifacts containing eagle feathers is not a taking because it does not compel the surrender of the property and there is no physical invasion or restraint upon the property); United States v. Central Eureka Mining Co., supra (order that prohibited operation of gold mines not a taking since the Government did not occupy, use or take physical possession of the gold mines or the equipment connected with them); Ommia Commercial Co. v. U.S., 261 U.S. 502 (1923) (requisition of steel company's production not a taking of a contractual right to purchase such production). Cf. United States v. Causley, 328 U.S. 256, 262-263, (1946) (direct overflights that destroyed value of land as chicken farm constituted a taking since the government had not "merely destroyed property [but was] using part of it for the flight of its planes").

E. The Tenth Amendment

The Tenth Amendment provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." In Oklahoma v. F.E.R.C., 661 F.2d 832 (10th Cir. 1981), cert. den. 102 S.C. 2902 (1982), the court of appeals upheld the NGPA against a challenge that it violated the Tenth Amendment. Since the NGPA abrogated or modified many contractual provisions for the sale of natural gas, even when that gas was consumed in the state in which it was produced, the similar provisions of the Natural Gas Consumer Regulatory Reform Amendment would also not violate the Tenth Amendment. This result is consistent with the decisions of the Supreme Court holding that regulating natural gas and electricity sold for resale in interstate commerce lies beyond the powers of the states[12/] and within Congress' power under the Commerce Clause.[13/]

Despite many requests that it do so, the Court consistently has refused to use the Tenth Amendment as a basis to invalidate federal regulation of private economic activities.[14/] The Court made clear in Hodel v. Virginia Surface Mining and

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[12/] E.g., Public Utilities Commission v. Attleboro Steam & Electric Co., 273 U.S. 83 (1927); Missouri ex rel. Barrett v. Kansas Natural Gas Co., 265 U.S. 298 (1924).

[13/] F.P.C. v. Natural Gas Pipeline Co., supra.

[14/] In National League of Cities v. Usery, 426 U.S. 833 (1976), the Supreme Court did invalidate a federal regulation on the basis of the Tenth Amendment. However, this case should be read very narrowly since it involved wages paid by the states to their employees.

Reclamation Association, supra, that Congress does not invade areas reserved to the states by the Tenth Amendment simply because it exercises its authority under the Commerce Clause in a manner that displaces the states' exercise of their police powers. In order for a federal law to invade powers reserved to the states three conditions must be met. First, there must be a showing that the statute regulates the "States as States." Second, the Federal regulation must address matters that are indisputably "attributes of state sovereignty." And third, it must be apparent that the States' compliance with the Federal law would directly impair their ability "to structure integral operations in areas of traditional governmental functions." 452 U.S. at 287-88.

Under this test congressional action to regulate natural gas contracts could not be held to infringe on areas reserved to the states by the Tenth Amendment. The proposed legislation would regulate the natural gas industry, not the states in their sovereign capacity. The states would remain free to regulate those aspects of the industry, such as production of gas and sale of gas to ultimate consumers, that are subject to the states' police powers.[15]

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[15] Even states themselves may become subject to federal regulation under the Commerce Clause when they engage in economic activities of a proprietary nature, similar to those of private parties. See Public Service Co. v. FERC, 587 F.2d 716 (5th Cir. 1979).

F. Prior Regulation of Natural Gas Contracts

It is well settled that Congress can exercise its power under the Commerce Clause to regulate the natural gas industry,[16/] including the production of gas for sale in the interstate[17/] and intrastate[18/] markets. On several occasions Congress has exercised this power to affect natural gas contracts directly.[19/] In Section 5(a) of the NGA Congress authorized the Commission to determine whether a "contract... is unjust, unreasonable, unduly discriminatory, or preferential...," and prescribe

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16/ In F.P.C. v. Natural Gas Pipeline Co., 315 U.S. 575, 582 (1942), the Supreme Court unanimously upheld the constitutionality of the NGA and approved a Commission order finding existing rates for sale of natural gas by two pipelines unjust, unreasonable and excessive under §§5(a) and 13 of the NGA and ordering a reduction of rates. In so doing, the Court stated:

> The argument that the provisions of the statute applied in this case are unconstitutional on their face is without merit. The sale of natural gas originating in one State and its transportation and delivery to distributors in any other State constitutes interstate commerce, which is subject to regulation by Congress.

17/ In Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), the Supreme Court directed the Commission to establish just and reasonable rates for sales in interstate commerce of natural gas for resale by all producers including independent producers that were not affilated with a pipeline.

18/ The NGPA imposed price controls on natural gas produced for sale in the intrastate market. The constitutionality of the NGPA as a whole was upheld in Oklahoma v. F.E.R.C., 494 F. Supp. 636 (W.D. Okla. 1980), aff'd 661 F.2d 832 (10th Cir. 1981), cert. den. 102 S.C. 2902 (1982).

19/ The Commerce Clause is the basis for the establishment of maximum and minimum prices under the NGA and the NGPA. Price controls may override inconsistent price terms in existing contracts. E.g., Permian Basin Area Rate Case, 390 U.S. 747, 821-822 (1968).

the "contract to be thereafter observed...." Pursuant to this section the Commission adopted a regulation that, in effect, abrogated all indefinite price escalators except for clauses which tied the price to the applicable just and reasonable area ceiling rate. The Supreme Court affirmed this action, holding that Section 5(a) gives "the Commission... plenary authority to limit or to prescribe contractual arrangements that contravene the relevant public interests."[20/]

In the NGPA, Congress acted directly to limit the application of private contractual provisions. Section 105(b)(3)(A)[21/] caps the price that can be paid pursuant to indefinite price

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[20/] 390 U.S. at 784. See also F.P.C. v. Texaco, 377 U.S. 33 (1964); Pure Oil Co., 25 F.P.C. 383 (1961), aff'd, Pure Oil Co. v. F.P.C., 299 F.2d 370 (7th Cir. 1962); 18 C.F.R. §154.93.

[21/] Section 105(b)(3)(A) provides:

> (A) IN GENERAL.--Effective January 1985, and each month thereafter, in the case of any first sale of natural gas, which is sold at a price established under any indefinite price escalator clause of any existing contract or successor to an existing contract and for which the contract price on December 31, 1984, is higher than $1.00 per million Btu's, the maximum lawful price under this section for any such natural gas delivered during any month shall be the higher of-
>
> > (i) the maximum lawful price, per million Btu's, computed under paragraph (2)(B); or
> >
> > (ii)(I) in the case of January 1985, the maximum lawful price, per million Btu's, computed under section 102 (relating to new natural gas) for such month; and
> >
> > (II) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under this clause for the immediately preceding month multiplied by the monthly equivalent of the sum of a factor equal to the annual inflation adjustment factor applicable for such month plus .03.

escalator clauses in intrastate contracts. Section 313[22/] shields indefinite price escalator clauses from the effect of certain natural gas prices. Section 314 declared unenforceable anti-commingling clauses that often are included in intrastate contracts.[23/]

[22/] Section 313 provides:

> (a) HIGH-COST NATURAL GAS.- No price paid in any first sale of high-cost natural gas (as defined in section 107(c)) may be taken into account in applying any indefinite price escalator clause (as defined in section 105(b)(3)(B)) with respect to any first sale of any natural gas other than high-cost natural gas (gas defined in section 107(c)).
>
> (b) OTHER TRANSACTIONS.- No price paid-
>
> (1) in any sale authorized under section 302(a), or
>
> (2) pursuant to any order issued under section 303(b), (c), (d), or (g),
>
> may be taken into account in applying any indefinite price escalator clause (as defined in section 105(b)(3)(B)).

[23/] Section 314(a) provides:

> (a) GENERAL RULE.- Any provision of any contract for the first sale of natural gas is hereby declared against public policy and unenforceable with respect to any natural gas covered by this Act if such provision-
>
> (1) prohibits the commingling of natural gas subject to such contract with natural gas subject to the jurisdiction of the Commission under the provisions of the Natural Gas Act;
>
> (2) prohibits the sale of any natural gas subject to such contract to, or transportation of any such natural gas by, any person subject to the jurisdiction of the Commission under the Natural Gas Act, or otherwise prohibits the sale or transportation in interstate commerce (within the meaning of the Natural Gas Act) of natural gas subject to such contract; or
>
> (3) terminates, or grants any party the option to terminate, any obligation under any such contract as a result of such commingling, sale, or transportation.

IV. Conclusion

Congress' power under the Commerce Clause to regulate the natural gas industry is extremely broad. It has used this power to modify and even abrogate provisions in contracts for the sale of natural gas. Any challenge to further regulation of natural gas contracts would not succeed since no express constitutional limitation would be violated. There would be no violation of substantive due process or equal protection since the Congress clearly would have a rational basis for its action, including any classification of natural gas contracts it might adopt. There would be no taking since the congressional action would only adjust economic relationships and would not involve the physical surrender of property to the government. There would be no invasion of the areas preserved to the states by the Tenth Amendment since these areas are very narrow and do not extend to the regulation of commodities sold in interstate commerce.

The CHAIRMAN. Senator Murkowski.

Senator MURKOWSKI. Thank you, Mr. Chairman.

I want to commend you. I think that your response to a wide variety of questions on this very complex legislative proposal certainly deserves the consideration of all of us.

I indicated in my opening remarks concern over contract carriage provisions, and I will speak directly with regard to the interest of our State.

As you well know, we are not linked to any lower 48 gas transmission network; hence, the major utilities or industrial users in our State cannot take advantage of the contract carriage provision in your proposal to the extent the lower 48 or major industrial users can.

It is evident on your chart showing the significant network and then the State of Alaska off in a corner.

As a consequence, our utilities cannot shop around, basically, for better gas deals to the extent that the lower 48 utility or user might use, and I am asking you, Mr. Secretary, has there been any consideration in your provision, in your legislation which would recognize the uniqueness of our State, and I believe some other areas in the Southwest that are under a similar set of circumstances and what provision might we expect, if any?

Secretary HODEL. Senator, we did not propose any special provisions with regard to this. It was in somewhat the same mode that we were in with regard to imports, in that we did not know how to draft a properly refined, targeted exception, if that is what it has to be.

Senator MURKOWSKI. We do not have the check and balance.

Secretary HODEL. I understand. So we have not dealt with it in this proposal. It is not excepted from the language of the bill as we presented it. It is something that, obviously, we will have to continue to analyze. But I do not have an answer as to how to do that effectively without opening up such an array of exceptions that we finally end up with a bill which has more exceptions than it has general processes to it.

Senator MURKOWSKI. I know. But in our situation, without some protection, we are exposed to the reality that in January of 1986, the price could go up to whatever, because there is no competitive factor, as there is in your application in the other areas of the country covered with the alternative availability of the pipeline network.

Secretary HODEL. What I hear you saying to me also is that there is no problem with the producer charging any price that the producer wants.

Senator MURKOWSKI. That is correct.

Secretary HODEL. That there is no restraint at all on the producer.

Senator MURKOWSKI. That is my concern.

Secretary HODEL. Obviously, that is a situation that we need to pursue.

Senator MURKOWSKI. Well, I would appreciate knowing if you intend to direct some attention to drafting a provision for the concern that I outlined.

Secretary HODEL. What I would like to do, Senator, is to see to it that, at the staff level, we clearly understand the dimensions of the situation, and the role that the State public utility commission can or cannot play in that before we would draft a provision which would make this a Federal responsibility.

Assuming that could be worked out at that level, it may direct us as to what language we should propose, if any.

Senator MURKOWSKI. Well, I will look forward to working with you. And in the event that our concerns are not addressed, then I would draft such a provision as an amendment.

I have two other brief questions, Mr. Chairman.

Is there anything in existing law, or would there be any provision under the law, assuming that this legislation is adopted, that would prevent or limit the State's right to regulate the wellhead price of gas sold exclusively in interstate commerce?

Secretary HODEL. Senator, the answer is that we do not intend in this bill to do that.

Senator MURKOWSKI. So the State would have the right to regulate the wellhead price?

Secretary HODEL. The only caveat to that would be if a challenge were raised, and it were interpreted that this bill in some way constituted a Federal preemption of that. Although, it is not the way we drafted the bill, nor our intention to do so.

Senator MURKOWSKI. Would it be your intention to give some clear intent in the drafting of the matter regarding this particular issue, because I think that it is something that is very important.

Secretary HODEL. I think we need to analyze that, Senator, and make sure that is the proper direction from the broad-policy view and that it would be expressed clearly what our intention is.

Senator MURKOWSKI. I would like the record to note the concern that we have over this matter with regard to States rights to regulate the wellhead price in interstate commerce, so the intention is clear that the State continue to have that right.

Secretary HODEL. I understand your interest and concern, Senator. We will pursue that, and will be very clear as to what our proposal should be.

Senator MURKOWSKI. Is there anything in the administration's proposal extending Federal regulation to interstate gas pipelines, or limiting the States right to regulate such pipelines?

Secretary HODEL. We extend the provisions, but we also permit the intrastate pipelines to acquire gas outside the State without falling under interstate regulatory controls. So there are some applications there. We try to provide an equal access provision.

Senator MURKOWSKI. So you are limiting the State's right?

Secretary HODEL. No, I think we are not imposing Federal restraint on intrastate pipelines if they seek gas outside the State.

Senator MURKOWSKI. But I asked for a clear intention.

Secretary HODEL. We will provide that, Senator. Yes, we will.

Senator MURKOWSKI. One other general concern. And that is the matter of the gas cap, and how it would actually operate in practice. I am wondering since there are so many unknowns in the development of the gas cap, and I am sorry to say that the last chart was taken down. I would like to refer to it very briefly.

Why would it not be more understandable, and I am asking whether in reality there would be any significant difference ultimately if you took the old gas and the new gas, and averaged them out to an average wellhead price, which would be if you took $1.25 and $3, and add them up, divide by 2, and you get what, $2.12 as an average wellhead price, and you are making certain assumptions there.

You are mixing old gas and new gas. You are assuming that you have got equal reserves. Then you have a known wellhead, which takes the risk out from the standpoint of how it is received from someone. It is up front now, which is in this case about 43 cents less than your $2.75, at $2.12.

Now that is a simplistic approach to a complex problem. But it froze out something that is readily understandable, because it is a figure that is there, and it compares with an average wellhead price that you said was somewhere between $2.75 and $3.

Secretary HODEL. The average wellhead price becomes important when we deal with the question of how much of an increase is allowed because of inflation, and as a benchmark against which a pipeline can move. Now the way it is proposed to operate in our bill, is that we have a volume-weighted average.

Because of the different volumes of gas, we just cannot, as you know, take all gas equally, add them up, and divide by the numbers of kinds of gas. We have to determine how many cubic feet of each is being incorporated.

We determine that average price. That is then used to determine the benchmark against which inflation is measured. So, to take an example, if the price were $3 average, and inflation were 10 percent, you would have a 30-cent increase which would be allowed as the inflationary factor in all pipeline prices.

So, that the $4 pipeline would have a 30-cent increase, and the $2 pipeline could have a 30-cent increase. So as a percentage, they would each actually move at different levels of percents, but the absolute amount would be the restriction.

So, in making that calculation, we felt it was important to have a real average. Frankly, picking an arbitrary figure there, or an assumed figure there, would be as contentious as most of the other provisions of this bill.

Senator MURKOWSKI. Well, I agree. My only concern is that in not providing a certainty from the gas cap, there is an area of concern, and I think some confusion in the process in which you go about it. And ultimately, is it going to be any different than a simple average, as I have suggested, making certain assumptions on reserves, which you have to do in any event, and certain assumptions on percentage of both mixes that are going in the market.

I see that my time is up. I would like to make that point, because I think that that is kind of hanging over all of us.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, very much, Senator. And thank you, Mr. Secretary. You have shown a great deal of patience and fortitude. We have already been here 3 hours. While you were not on the stand for all of those 3 hours, you were nevertheless here, and listening very carefully and continuously during that period before you came to the table.

Mr. Secretary, as you know, these hearings are on all pending bills relating to the gas issue. We would like to have written detailed departmental reports from you on the other pending bills as well.[1]

Mr. Secretary, I think that it would be helpful and almost essential to this committee to look at individual pipeline effects. And there will be some big losers, and some big winners, when we look at the variations between the market effects on individual pipelines.

We have some of the basic data, which has been furnished to us by IEA and from other sources. We would like to have your comments with respect to your own analysis, to your own expectation as to what would happen to those pipelines.

While I know that that is very difficult to discuss, nevertheless, it is going to be discussed before we get to the end of this.

There are a number of other questions which will be submitted in writing. But in regard to Senator Murkowski's question about the effect on State law, I invite your attention to section 602(a) of the existing law, and the effects that it will have under section 201 of the proposed legislation as it modifies section 121 of NGPA.

Section 602(a) in effect says that the States can regulate as long as the price is lower than the regulated price. And I do not know what effect that will have with respect to the caps which are established here during the period of time between now and January 1, 1986.

You can submit that for the record, if you will. The record will remain open for your responses to the questions which will be submitted in writing.

Secretary HODEL. Senator, I would like to expand to that in writing. But our impression is at this moment that we would not expect to interfere, if States had the authority and chose to regulate different lower prices. That would not be something with which we would intend to interfere. But I will pin that down in writing.

The CHAIRMAN. All right, if you would do so. And any questions which are submitted by the close of business tomorrow will be submitted to you in writing for your response in writing. And I would hope that you can, if the volume is not excessive, have those answers back to us in a week, so that they may be included in the record.

Mr. Secretary, thank you, very much. This committee will stand in recess until tomorrow morning when we will again resume consideration of the pending bills.

[Whereupon, at 1:05 p.m., the hearing recessed, to reconvene on Thursday, March 10, 1983.]

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[1] This report is being provided under separate cover to the committee.

NATURAL GAS LEGISLATION

THURSDAY, MARCH 10, 1983

U.S. Senate,
Committee on Energy and Natural Resources,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-366, Dirksen Office Building, Hon. James A. McClure (chairman) presiding.

Present: Senators McClure, Murkowski, Hecht, Johnston, Ford, and Metzenbaum.

Also present: Charles A. Trabandt, chief counsel; E. David Doane, deputy chief counsel for energy; Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. JAMES A. McCLURE, A U.S. SENATOR FROM THE STATE OF IDAHO

The **Chairman**. Good morning. The committee will come to order, please.

Today's hearing is the second session of the committee's hearings on pending natural gas legislation. Yesterday, the Secretary of Energy presented testimony on the administration's bill, S. 615. This morning, we will hear from four Senators representing States in which increases in gas prices have been particularly severe.

We will also receive testimony from three panels of witnesses, who will undoubtedly present a wide range of views on the proposed legislative remedies that are now before the committee.

I would particularly like to welcome our lead-off witness this morning. It is a return engagement for her, having testified last December on a number of proposals on restraining gas prices. It is a particular pleasure to have the junior Senator from the State of Kansas before us this morning, Hon. Nancy Kassebaum. You may proceed.

STATEMENT OF HON. NANCY LANDON KASSEBAUM, A U.S. SENATOR FROM THE STATE OF KANSAS

Senator **Kassebaum**. Thank you, Mr. Chairman. It is a pleasure to be back before you again. And I would like to say that I very much appeciate the opportunity to testify again on an issue that not only the Energy Committee, but many of the rest of us have deep concern.

In many ways, I think that I am uniquely representative of a State that not only is having trouble with the consumers, but the producers in the pipelines as well. And I would just like to start this morning by reviewing briefly what has happened since the hearing that you held in the lameduck session, in which I tried successfully along with Senator Danforth, and Senator Eagleton, and Senator Jepsen, and others to promote legislation which we felt would be of benefit.

And since that time, absolutely nothing has happened. And this is one of the reasons that I am sure that this committee is anxious to find the answers just as much as we are.

When I introduced legislation last fall, I identified it as an attempt to give some small measure of relief to consumers while the investigation of the comprehensive report of the NGPA was being made. This is something, I know, that has been of concern to you, Mr. Chairman.

The Senate, of course, at that point chose not to follow that course, and that effort failed. And far, however, from solving any problems, we have only continued to accumulate them at the expense of the consumers, who are continually seeing prices being escalated to them as the rest of the industry fails.

In times of excess deliverability, we have seen continued upward pressure on the prices of the consumers. And we have been blessed in many ways with the relatively mild winter, which has prevented the situation from becoming tragic.

The problems are well established. I think that we all realize them, and know them. And it is time now to turn to the causes of those problems and solutions. In that regard, I certainly do applaud the courage of the administration in bringing forth the proposal to begin the debate.

The administration plan has some very interesting and innovative parts. Unfortunately, I believe that it also has a fatal flaw. Briefly stated, that flaw is the fact that the bill, S. 615, creates a tremendous upward pressure on average wellhead prices by decontrolling old gas.

At the same time, the bill fails in its attempt to insure that the pipelines have a long-term incentive to bargain aggressively for the lowest cost for the gas that they purchase.

The problems today stem in part not from having different prices for different categories, but rather from having most gas controlled, and one category of gas totally decontrolled. By decontrolling old gas before distortions in the marketplace are correct, the administration's plan would cause the price to increase dramatically on over 40 percent of the gas in this country.

True, this would cause the price of the expensive section 107 gas to moderate somewhat. However, since section 107 gas only constitutes approximately 5 percent of our supply, it does not take an expert to see what would happen to average wellhead prices.

In fact, a recent study by a consumer group indicates that this would cause residential gas bills to increase by approximately 67 percent over the next 4 years. Even if this figure should prove exaggerated, we cannot ask the consumer to bear that risk.

The administration has stated that this 67-percent increase could not occur because this bill contains ironclad consumer protection. I would like to take a look for a moment at this ironclad protection.

Because it is something that when I first heard about the administration's bill, and before it was introduced, believed that indeed it would provide protection. However, as it is drafted, I really feel that it does not.

Section 101(a) of the bill says that a pipeline may not recover a higher purchased gas cost except to the extent of inflation. Section 101(b) of the bill shatters any illusion that consumers might have had over their protection.

Section 101(b) establishes a new mechanism for the pipelines to recover the amount that was disallowed under 101(a). It does not return to the older ratemaking provisions that existed under section 405.

And who then under this new provision would allow or reject this additional recovery, but the Federal Energy Regulatory Commission. Also, on top of this, on December 31, 1985, even this limited protection disappears.

After that, it is back to business as usual with the automatic PGA subject only to the toothless fraud and abuse standard. Given the very real possibility of upward movement of wellhead prices under the President's plan, this protection is a fraud on the consuming public.

Now I do not mean to imply, Mr. Chairman, that I think that it was an obvious fraud on the part of the administration in drafting it this way. Because I think that in many ways, their approach is innovative. But I think that it is a misleading protection. While well intended, I do not think that it would serve as a mechanism for protection.

It is incumbent on those of us with a true concern for the consumers of this country not just to criticize the administration's plan, but to present an alternative. I intend to do just that along with others who will be testifying here today in introducing legislation in the near future, which will comprehensively, I believe, address the problems existing in the market today.

I am sure that all of us are familiar with the main points of the plan that I am going to describe, as it shares some of the aspects of the bill that will be introduced in the House early next week.

This plan will take principles of the bill that I introduced in the fall, which was intended as temporary relief, and incorporate them into a permanent thorough approach to bringing relief to the gas consumers of this country.

The vast reservoir of old gas serves as an anchor of most of our major pipeline systems. It serves as a cushion to support the exploration for more expensive gas without unduly raising consumer prices. This gas should not be decontrolled until distortions in the marketplace have been corrected.

But the basic premise of continued controls on old gas in mind, I would like briefly to go through some of the plan that is under consideration. One, the NGPA ceiling prices would be rolled back to their October 1, 1982 levels, and allow it to increase at a rate no greater than 75 percent of inflation.

In addition, the 1985 and 1987 decontrol dates in the NGPA would be extended 2 years. High cost section 107 gas would be capped at 150 percent of the 103 price subject to a case-by-case review by FERC as to whether such a rate is just and reasonable for a particular well or producer.

The provisions of the NGPA, which may give FERC the power to raise ceiling prices and/or create new incentive categories would be repealed. I refer specifically to sections 104(b)(2), 106(c), 109(b)(1), and 107(c)(5).

Take or pay obligations above 50 percent of date of deliverability will be repealed. This would continue for 3 years after enactment. The producer would be free to sell the gas represented by the reduced take subject to a right of first refusal by the pipeline.

Subject to capacity, the pipeline would be required to transport the gas to the new purchaser for a reasonable charge. Both parties to contracts for high cost gas shall have a market-out opportunity if renegotiations fail.

The pipeline would be required to transport the gas to a new purchaser on terms similar to those described above. Most-favored-nation type clauses and indefinite price escalator clauses would be outlawed.

Section 601(c) would be left intact with imprudence added to the fraud and abuse standard. FERC would be required to establish a rate design which would force the pipelines to consider the effects that their purchasing practices have on the end user market.

I think that another very important provision of this would be imports of Algerian LNG would be capped at 150 percent of the 103 price. The President would be required to report to Congress within 60 days, in efforts, to renegotiate the border price of Canadian and Mexican gas to more realistic levels.

This decription briefly was intended to hit the high points of the plan, and really not to describe it in detail. I think, Mr. Chairman, that this plan represents a viable alternative to that of the administration. And I know that your committee will be taking a very serious and thoughtful look at the various proposals that would be put forward.

And I have every confidence that the Energy Committee will be able to come up with a solution that is going to resolve this very thorny problem, which has long been a battle with the various participants still trying to resolve a concern which we all share. Thank you, Mr. Chairman.

[The prepared statement of Senator Kassebaum follows:]

TESTIMONY OF SENATOR NANCY LANDON KASSEBAUM

BEFORE THE COMMITTEE ON ENERGY AND NATURAL RESOURCES

MARCH 10, 1983

Mr. Chairman, I appreciate the opportunity to testify today before this committee. Your willingness to hold two major hearings on the natural gas issue in the space of a few months is commendable. I believe that these hearings are a measure of the seriousness of the problems facing gas consumers today.

I would like to begin this morning by reviewing for a moment what has happened since the hearing which was held during the lame duck session last fall. Such a review will not take long, because absolutely nothing has happened to give any relief to the beleaguered consumers of natural gas in this country. When I introduced my legislation last fall, I indentified it as an attempt to give some small measure of relief to consumers while we investigated a comprehensive reform of the N.G.P.A. The Senate chose not to follow that course, and, as a result, gas consumers must now suffer while Congress works its tortuous way through the quagmire of a comprehensive gas bill.

Far from having been given any relief from high gas costs, consumers have seen FERC heap even more costs upon them. In a recent decision, FERC has allowed producers to recover certain costs of gathering and compressing gas, over and above their ceiling price revenues. This decision will cost consumers approximately $6 billion in higher gas bills over the next two years. Meanwhile, average wellhead prices continue their inexorable climb upward in a time of excess deliverability. Only a comparatively mild winter has prevented a true tragedy from occurring.

So much for the past. We are faced today with the task of beginning work on a comprehensive overhaul of the N.G.P.A. The problems are well established; it is time now to turn to the causes of those problems and their solutions. In that regard, I applaud the courage of the administration in bringing forth a proposal to begin the debate. The administration plan has some very interesting and innovative parts. Unfortunately, I believe that it also has a fatal flaw. Briefly stated, that flaw is the fact that the bill, S.615, creates a tremendous upward pressure on average wellhead prices by decontrolling old gas. At the same time, the bill fails in its attempt to ensure that the pipelines have a long-term incentive to bargain aggressively for the lowest possible cost for the gas they purchase.

The problems today stem, in part, not from having different prices for different categories, but rather from having most gas controlled and one category of gas totally decontrolled. By decontrolling old gas, before distortions in the market place are corrected, the administration's plan would cause the price to increase dramatically on over 40 percent of the gas in this country.. True, this would cause the price of the expensive Sec.107 gas to moderate somewhat. However, since that Sec.107 gas only constitutes approximately 5 percent of our supply, it does not take an expert to see what will happen to average wellhead prices. In fact, a recent study by a consumer group indicates that this would cause residential gas bills to increase by approximately 67 percent over the next four years. Even if this figure should prove exaggerated, we cannot ask the consumer to bear that risk.

The administration has stated that this 67 percent increase could not occur because their bill contains "ironclad" consumer protection. Let's take a close look at that "ironclad" protection. Section 101(a) of the bill says that a pipeline may not recover a higher purchased gas cost except to the extent of inflation. That sounds very promising. Section 101(b) of the bill shatters any illusions that consumers might have had over their "protection." Section 101(b) establishes a new mechanism for the pipelines to recover the amount that was disallowed under 101(a)! And who is to allow or reject this additional recovery? FERC. To top all this off, on December 31, 1985, even this limited protection disappears. After that, it is back to business as usual with automatic PGA's subject only to the toothless fraud and abuse standard. Given the very real possibility of upward movement of wellhead prices under the President's plan, this "protection" is a fraud on the consuming public.

It is incumbent upon those of us with a true concern for the consumers of this country not just to criticize the administration's plan, but to present an alternative. I intend to do just that by introducing legislation in the near future which will comprehensively address the problems existing in the market today. I am sure that all of you are familiar with the main points of the plan that I am going to describe, as it shares some of the aspects of the bill that will be introduced in the House early next week. This plan will take principles of the bill I introduced in the fall, which was intended as temporary relief, and incorporate them into a permanent, thorough approach to bringing relief to the gas consumers of this country.

The vast reservoir of old gas serves as an anchor of most of our major pipeline systems. It serves as a cushion to support the exploration for more expensive gas without unduly raising consumer prices. This gas should not be decontrolled until distortions in the market place have been corrected.

With the basic premise of continued controls on old gas in mind, I would like to briefly list the other main points of the plan that I intend to introduce:

1) The NGPA ceiling prices would be rolled-back to their October 1, 1982, levels and allowed to increase at a rate no greater than 75 percent of inflation. In addition, the '85 and '87 decontrol dates in the NGPA would be extended two years.

2) High cost, Section 107 gas would be capped at 150 percent of the 103 price, subject to a case-by-case review by FERC as to whether such a rate is just and reasonable for a particular well or producer.

3) The provisions in the NGPA which may give FERC the power to raise ceiling prices and/or create new incentive categories would be repealed. I refer specifically to Sections 104(b)(2), 106(c), 109(b)(2) and 107(c)(5).

4) Take-or-pay obligations above 50 percent of daily deliverability would be repealed. This would continue for three years after enactment. The producer would be free to sell the gas represented by the reduced take, subject to a right-of-first-refusal by the pipeline. Subject to capacity, the pipeline would be required to transport the gas to a new purchaser for a reasonable charge.

5) Both parties to contracts for high-cost gas shall have a market-out opportunity if renegotiations fail. The pipeline would be required to transport the gas to a new purchaser on terms similar to those described above.

6) Most-favored nation type clauses and indefinite price escalator clauses would be outlawed.

7) Section 601(c) would be left intact, with imprudence added to the fraud and abuse standard.

8) FERC would be required to establish a rate design which would force the pipelines to consider the effects that their purchasing practices have on the end-user market.

9) Imports of Algerian LNG would be capped at 150 percent of the 103 price.

10) The President would be required to report to Congress within 60 days on efforts to renegotiate the border price of Canadian and Mexican gas to more realistic levels.

This description was intended to hit the high points of my plan, not to describe it in detail. I believe that this plan represents a viable alternative to that of the administration. I urge this committee to use it as a starting point in reaching a package which will truly help the people who are suffering the most from the current distorted market place for natural gas.

The CHAIRMAN. Thank you, very much, for your statement. I have just a couple of questions, so that I might understand your proposal a little better.

When you say high cost section 107 gas would be capped at 150 percent of the 103 price, are you talking about a rollback of existing contracts?

Senator KASSEBAUM. Well, that would be subject to review by FERC.

The CHAIRMAN. But it would be a rollback of the existing contracts on existing production?

Senator KASSEBAUM. Yes.

The CHAIRMAN. And similarly, I assume that in your paragraph 4, you are suggesting that the take-or-pay obligation would be subject to that same kind of thing, whatever the price cap is?

Senator KASSEBAUM. That is right.

The CHAIRMAN. For the class of gas that we are discussing under the take-or-pay provision?

Senator KASSEBAUM. That is right.

The CHAIRMAN. And paragraph 9 on the imports of Algerian LNG, that would be a rollback of the existing price, is that correct?

Senator KASSEBAUM. That is right.

The CHAIRMAN. Thank you, very much. I appreciate your testimony.

Senator KASSEBAUM. Thank you, Mr. Chairman.

The CHAIRMAN. We will next hear from our colleagues from Missouri. Again, as I said earlier, this is a replay of last December. We welcome the opportunity to hear from our friends from the State of Missouri, the Honorable John Danforth and Tom Eagleton, both of whom appeared before.

I would say to Senator Kassebaum, you are welcome to stay or to leave, as you see fit.

Senator KASSEBAUM. The Budget Committee calls.

The CHAIRMAN. Well, I will not feel offended if you do not want to hear your colleagues' testimony. [Laughter.]

Jack.

STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator DANFORTH. Mr. Chairman, thank you, very much. I want to say to you and to Senator Eagleton that I think that I am going to be in the same position with respect to Senator Eagleton as Senator Kassebaum is with respect to us. Because I, too, have a subcommittee meeting, which I have to chair in about 15 minutes. But I do appreciate your patience in holding these very extended hearings.

Mr. Chairman, in holding these hearings on natural gas policy, the committee has two key questions to consider. What should be done about current market conditions, and what should be done about old gas.

The administration now has come forward with its answers. In my judgment, these answers are respectfully inadequate and wrong. I believe that stronger action is needed on market conditions than the administration proposes. And I believe that no action at all should be taken to deregulate old gas.

The impetus for new natural gas legislation comes from the fact that prices continue to rise despite the surplus of supply that exists on the market today. Cheap gas goes begging while expensive gas continues to flow. Wellhead prices increase precisely in step with the ceilings proscribed in the Natural Gas Policy Act of 1978.

The reasons are readily apparent. At a time of shortage, producers capitalized on a seller's market by insisting on contract clauses that guaranteed the maximum possible return. Pipeline companies overly anxious to get additional supply agreed to such clauses. Consumers are paying for those mistakes today.

After years of seemingly unlimited demand for their product in a regulated market, pipelines have suddenly discovered that the law of supply and demand applies to sales as well as purchases.

They cannot sell the gas that they have for the price they want. But the contract clauses that they so foolishly entered into now prevent them for adjusting the changes in the marketplace.

I believe that we should release pipeline companies from these contract clauses. Such a step would not be a bailout of the pipelines. It would be a bailout of the consumer, who must foot the bill for the pipelines' errors or judgment.

In recent years, some pipelines agreed to pay very high prices for their new supplies of gas. At existing demand levels, the new gas could be blended with large quantities of old gas with little impact on the price.

But as demand dropped, the amount of new gas purchased was held constant by take-or-pay clauses. And the amount of cheap old qas blended with it cut further and further back. Even with no change in wellhead prices, the cost to the consumer rose dramatically.

The administration proposes to allow pipelines to reduce their takes to 70 percent of available deliverability with the producers set free to sell the remainder elsewhere. This approach, at least, recognizes the problem, and takes a step in the direction of solving it, but it is clearly insufficient.

Total abrogation of these clauses would be better by far. For the pipeline serving Kansas City, Mo., such a step would result in an immediate price reduction of approximately 25 percent.

Some pipelines also agreed to escalator clauses tying the price of their gas to the steadily rising price ceilings in the NGPA. At a time of sky-high oil prices, the NGPA ceilings seemed low, and the gas was more than competitive.

But now oil prices are dropping, and gas prices continue to rise. Industries are switching to fuel oil.

Mr. Chairman, I have one page of information, which I would like inserted in the record relating to the switch from natural gas to fuel oil both in Kansas City and St. Louis.

The CHAIRMAN. It will be made a part of the record.

Senator DANFORTH. The result is that fewer and fewer customers share the fixed cost of the pipeline system, and thus prices rise still further. Missouri's two biggest gas utilities are losing a substantial number of their industrial customers to fuel oil. That is the data that is being included with the statement.

Again, the administration recognizes the problem, and proposes a solution. But again the solution is inadequate. Prices would be limited to the average price set in new and renegotiated contracts.

Under current market conditions, that might provide a small measure of relief. But if oil prices were to rise again, or if economy recovery tightens supply conditions, this price cap would provide no relief at all. Again, abrogation is a better answer by far.

S. 291 couples abrogation of these contract clauses with an imprudence standard. If a pipeline failed to exercise due prudence in securing the least-cost mix of gas, the Federal Energy Regulatory Commission would have the authority to deny recovery of the excess cost.

Such a combination in my judgment would remedy the most harmful distortions now present in the natural gas market.

Mr. Chairman, decontrol of old gas prices is the central and most damaging flaw in the administration's natural gas proposal. The decision to keep old gas under permanent price controls was an essential element of the compromise that resulted in the passage of the NGPA. The need for increased supply was balanced against the need to protect consumers, and the desire to avert a massive windfall to producers of old gas.

I supported that compromise, and still do. Removal or price controls on old gas will not result in the discovery of one more cubic foot of gas. It will simply line the pockets of the major oil companies that control more than 70 percent of the supply.

Indeed the supply effects would be negative. Low old gas prices enable pipeline companies to pay higher prices than they otherwise would for additional supplies. We need those supplies, and it makes sense to pay an incentive to get them.

These conditions have encouraged producers to search for gas confident that they could sell it under the price structure that had been created. Without price controls on old gas, that availability would be severely diminished or destroyed.

Clearly, the benefit to be gained from deregulating old gas in no way compares to the damage that would be done.

Mr. Chairman, 3 months ago, I was before this panel arguing for immediate action to deal with the skyrocketing price of natural gas. It was my hope then to achieve some small measure of relief for consumers this winter. Those arguments did not carry the day, and no relief is forthcoming.

But I am back today to say that the need for prompt action is not less now than it was 3 months ago. Under existing law, pricing changes takes several months to register on consumers' bills. And thus, action is needed soon to have an effect on the prices to be paid next winter.

We were fortunate this year to have unusually mild weather blunting the impact of the price changes that we have experienced. We may not be so lucky again next year.

Severe winter weather would inflect terrible hardship and suffering on the gas consumers of this country, if we fail to act.

I believe that S. 291 and S. 293 would do much to bring gas prices down without abandoning the compromise that we agreed to in the Congress 5 years ago. I strongly urge the committee to move quickly on these bills to provide consumers with the relief that they so badly need.

Mr. Chairman, again, my thanks for your diligence in holding these very extended hearings, and your patience to listening to all of this testimony.

[The prepared statement of Senator Danforth follows:]

STATEMENT OF SENATOR JOHN C. DANFORTH
ON PENDING NATURAL GAS LEGISLATION
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
MARCH 10, 1983

MR. CHAIRMAN, IN HOLDING THESE HEARINGS ON NATURAL GAS POLICY, THE COMMITTEE HAS TWO KEY QUESTIONS TO CONSIDER: WHAT SHOULD BE DONE ABOUT CURRENT MARKET CONDITIONS, AND WHAT SHOULD BE DONE ABOUT "OLD" GAS?

THE ADMINISTRATION NOW HAS COME FORWARD WITH ITS ANSWERS. IN MY JUDGMENT THESE ANSWERS ARE, RESPECTIVELY, INADEQUATE AND WRONG. I BELIEVE THAT STRONGER ACTION IS NEEDED ON MARKET CONDITIONS THAN THE ADMINISTRATION PROPOSES, AND I BELIEVE THAT NO ACTION AT ALL SHOULD BE TAKEN TO DEREGULATE OLD GAS.

THE IMPETUS FOR NEW NATURAL GAS LEGISLATION COMES FROM THE FACT THAT PRICES CONTINUE TO RISE DESPITE THE SURPLUS OF SUPPLY THAT EXISTS ON THE MARKET TODAY. CHEAP GAS GOES BEGGING WHILE EXPENSIVE GAS CONTINUES TO FLOW. WELLHEAD PRICES INCREASE PRECISELY IN STEP WITH THE CEILINGS PRESCRIBED IN THE NATURAL GAS POLICY ACT OF 1978.

THE REASONS ARE READILY APPARENT. AT A TIME OF SHORTAGE, PRODUCERS CAPITALIZED ON A SELLER'S MARKET BY INSISTING ON CONTRACT CLAUSES THAT GUARANTEED THE MAXIMUM POSSIBLE RETURN. PIPELINE COMPANIES, OVERLY ANXIOUS TO GET ADDITIONAL SUPPLY, AGREED TO SUCH CLAUSES. CONSUMERS ARE PAYING FOR THOSE MISTAKES TODAY.

AFTER YEARS OF SEEMINGLY UNLIMITED DEMAND FOR THEIR PRODUCT IN A REGULATED MARKET, PIPELINES HAVE SUDDENLY DISCOVERED THAT THE LAW OF SUPPLY AND DEMAND APPLIES TO SALES AS WELL AS PURCHASES: THEY CAN'T SELL THE GAS THEY HAVE AT THE PRICE THEY WANT. BUT THE CONTRACT CLAUSES THEY SO FOOLISHLY ENTERED INTO NOW PREVENT THEM FROM ADJUSTING TO THE CHANGES IN THE MARKETPLACE.

I BELIEVE WE SHOULD RELEASE PIPELINE COMPANIES FROM THESE CONTRACT CLAUSES. SUCH A STEP WOULD NOT BE A BAILOUT OF THE PIPELINES--IT WOULD BE A BAILOUT OF THE CONSUMER, WHO MUST FOOT THE BILL FOR THE PIPELINES' ERRORS OF JUDGMENT.

SOME PIPELINES AGREED TO PAY VERY HIGH PRICES FOR THEIR NEW SUPPLIES OF GAS. AT EXISTING DEMAND LEVELS, THE NEW GAS COULD BE BLENDED WITH LARGE QUANTITIES OF OLD GAS WITH LITTLE IMPACT ON PRICE. BUT AS DEMAND DROPPED, THE AMOUNT OF NEW GAS PURCHASED WAS HELD CONSTANT BY TAKE-OR-PAY CLAUSES, AND THE AMOUNT OF CHEAP, OLD GAS BLENDED WITH IT WAS CUT FURTHER AND FURTHER BACK. EVEN WITH NO CHANGE IN WELLHEAD PRICES, THE COST TO THE CONSUMER ROSE DRAMATICALLY.

THE ADMINISTRATION PROPOSES TO ALLOW PIPELINES TO REDUCE THEIR TAKES TO 70 PERCENT OF AVAILABLE DELIVERABILITY, WITH THE PRODUCER SET FREE TO SELL THE REMAINDER ELSEWHERE. THIS APPROACH AT LEAST RECOGNIZES THE PROBLEM AND TAKES A STEP IN THE DIRECTION OF SOLVING IT. BUT IT IS CLEARLY INSUFFICIENT.

Total abrogation of these clauses would be better by far. For the pipeline serving Kansas City, Missouri, such a step would result in an immediate price reduction of approximately 25 percent.

Some pipelines also agreed to escalator clauses tying the price of their gas to the steadily rising price ceilings in the NGPA. At a time of sky-high oil prices, the NGPA ceilings seemed low, and the gas was more than competitive. But now oil prices are dropping, and gas prices continue to rise. Industries are switching away to fuel oil. The result is that fewer and fewer customers share the fixed costs of the pipeline system, and thus prices rise still further. Missouri's two biggest gas utilities are losing a substantial number of their industrial customers to fuel oil. I am including specific data with my statement for the record.

Again, the Administration recognizes the problem and proposes a solution, but again the solution is inadequate. Prices would be limited to the average price set in new and renegotiated contracts. Under current market conditions, that might provide a small measure of relief. But if oil prices were to rise again, or if the economic recovery tightened supply conditions, this price cap would provide no relief at all. Again, abrogation is a better answer by far.

S. 291 COUPLES ABROGATION OF THESE CONTRACT CLAUSES, WITH AN IMPRUDENCE STANDARD. IF A PIPELINE FAILED TO EXERCISE DUE PRUDENCE IN SECURING THE LEAST-COST MIX OF GAS, THE FEDERAL ENERGY REGULATORY COMMISSION WOULD HAVE THE AUTHORITY TO DENY RECOVERY OF THE EXCESS COSTS. SUCH A COMBINATION, IN MY JUDGMENT, WOULD REMEDY THE MOST HARMFUL DISTORTIONS NOW PRESENT IN THE NATURAL GAS MARKET.

MR. CHAIRMAN, DECONTROL OF OLD GAS PRICES IS THE CENTRAL AND MOST DAMAGING FLAW IN THE ADMINISTRATION'S NATURAL GAS PROPOSAL. THE DECISION TO KEEP OLD GAS UNDER PERMANENT PRICE CONTROLS WAS AN ESSENTIAL ELEMENT OF THE COMPROMISE THAT RESULTED IN PASSAGE OF THE NGPA. THE NEED FOR INCREASED SUPPLY WAS BALANCED AGAINST THE NEED TO PROTECT CONSUMERS AND THE DESIRE TO AVERT A MASSIVE WINDFALL TO PRODUCERS OF OLD GAS. I SUPPORTED THAT COMPROMISE AND STILL DO.

REMOVAL OF PRICE CONTROLS ON OLD GAS WILL NOT RESULT IN THE DISCOVERY OF ONE MORE CUBIC FOOT OF GAS--IT WILL SIMPLY LINE THE POCKETS OF THE MAJOR OIL COMPANIES THAT CONTROL MORE THAN 70 PERCENT OF THE SUPPLY. INDEED, THE SUPPLY EFFECTS WOULD BE NEGATIVE: LOW OLD GAS PRICES ENABLE PIPELINE COMPANIES TO PAY HIGHER PRICES THAN THEY OTHERWISE WOULD FOR ADDITIONAL SUPPLIES. WE NEED THOSE SUPPLIES, AND IT MAKES SENSE TO PAY AN INCENTIVE TO GET THEM. THESE CONDITIONS HAVE ENCOURAGED PRODUCERS TO SEARCH FOR GAS, CONFIDENT THAT THEY COULD SELL IT UNDER THE

PRICE STRUCTURE THAT HAD BEEN CREATED. WITHOUT PRICE CONTROLS ON OLD GAS, THAT ABILITY WOULD BE SEVERELY DIMINISHED OR DESTROYED. CLEARLY, THE BENEFIT TO BE GAINED FROM DEREGULATING OLD GAS IN NO WAY COMPARES TO THE DAMAGE THAT WOULD BE DONE.

MR. CHAIRMAN, THREE MONTHS AGO I WAS BEFORE THIS PANEL ARGUING FOR IMMEDIATE ACTION TO DEAL WITH THE SKYROCKETING PRICE OF NATURAL GAS. IT WAS MY HOPE THEN TO ACHIEVE SOME SMALL MEASURE OF RELIEF FOR CONSUMERS THIS WINTER. THOSE ARGUMENTS DID NOT CARRY THE DAY, AND NO RELIEF WAS FORTHCOMING. BUT I AM BACK TODAY TO SAY THAT THE NEED FOR PROMPT ACTION IS NO LESS NOW THAN IT WAS THREE MONTHS AGO.

UNDER EXISTING LAW, PRICING CHANGES TAKE SEVERAL MONTHS TO REGISTER ON CONSUMERS' BILLS, AND THUS ACTION IS NEEDED SOON TO HAVE AN EFFECT ON THE PRICES TO BE PAID NEXT WINTER. WE WERE FORTUNATE THIS YEAR TO HAVE UNUSUALLY MILD WEATHER BLUNTING THE IMPACT OF THE PRICE CHANGES WE HAVE EXPERIENCED; WE MAY NOT BE SO LUCKY AGAIN NEXT YEAR. SEVERE WINTER WEATHER WOULD INFLICT TERRIBLE HARDSHIP AND SUFFERING ON THE GAS CUSTOMERS OF THIS COUNTRY IF WE FAIL TO ACT. I BELIEVE THAT S. 291 AND 293 WOULD DO MUCH TO BRING GAS PRICES DOWN, WITHOUT ABANDONING THE COMPROMISE WE AGREED TO IN THE CONGRESS FIVE YEARS AGO. I STRONGLY URGE THE COMMITTEE TO MOVE QUICKLY ON THESE BILLS, TO PROVIDE CONSUMERS WITH THE RELIEF THEY SO BADLY NEED.

ADDITIONAL INFORMATION FOR THE RECORD

IN MISSOURI, AS ELSEWHERE, THE PRICE OF NATURAL GAS APPEARS TO HAVE PASSED THE MARKET CLEARING LEVEL WITHOUT ANY SIGN OF DECREASING. THE GAS SERVICE COMPANY OF KANSAS CITY REPORTS THAT IT RECENTLY HAS LOST AN ESTIMATED 8 BILLION CUBIC FEET, OR ABOUT 20 PERCENT, OF ITS INDUSTRIAL LOAD TO NO. 6 FUEL OIL. THE COMPANY'S INDUSTRIAL RATE OF $4.52 HAS PASSED THE COMPARABLE PRICE FOR OIL OF SLIGHTLY MORE THAN $4. THE COMPANY CONSIDERS ANOTHER 7 BILLION CUBIC FEET OF ITS INDUSTRIAL LOAD TO BE IMMEDIATELY AT RISK--MAKING THE POTENTIAL LOSS AS MUCH AS ONE-THIRD OF ITS INDUSTRIAL LOAD.

LACLEDE GAS COMPANY OF ST. LOUIS, WITH AN INDUSTRIAL GAS PRICE OF BETWEEN $5.70 AND $6.10, FINDS ITSELF UNABLE TO APPROACH THE COMPARABLE PRICE OF NO. 6 FUEL OIL. IT ESTIMATES THAT IT RECENTLY HAS LOST ABOUT 6 BILLION CUBIC FEET, OR NEARLY 10 PERCENT OF ITS INDUSTRIAL LOAD, TO FUEL SWITCHING. ANOTHER 4 TO 6 BILLION CUBIC FEET IS CONSIDERED IMMEDIATELY AT RISK.

The CHAIRMAN. Thank you, very much. You have submitted some information for the record, and that will be included in the record. And I appreciate your testimony.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. I might just state parenthetically that the proposal for total abrogation of the take or pay contracts must be tempered by some kind of an analysis of what happens to the financial viability of some producers who have only limited supplies that were produced and developed under take-or-pay contracts with that pricing in mind.

We will have to analyze that as well. I do not know if you have any comment with respect to that.

Senator DANFORTH. I think that any time that any change is made with respect to energy policy, clearly the effect of such a change on all parts of the system of producing and delivering natural gas must be considered.

I would simply point out that with respect particularly to the western part of our State, that the presence of these take-or-pay contracts is, I think, without much question the leading cause of runup in natural gas prices, because of the really diminishing segment of the total gas which is sold, which is the low price natural gas.

The CHAIRMAN. Thank you, very much, Senator.

Senator DANFORTH. Thank you, Mr. Chairman.

The CHAIRMAN. Do either of my colleagues wish to ask Senator Danforth any questions?

Senator FORD. No questions, Mr. Chairman.

The CHAIRMAN. Thank you, very much.

We will now hear from the senior Senator from Missouri, Tom Eagleton. Tom, welcome back before this committee.

STATEMENT OF HON. THOMAS F. EAGLETON, A U.S. SENATOR FROM THE STATE OF MISSOURI

Senator EAGLETON. Thank you, Mr. Chairman, and I shall be brief. Because my views and that of Senators Kassebaum and Danforth are virtually identical, and I see no need to replow for the third time the same ground. We are working together, the three of us, to formulate a bill that is somewhat similar, if not identical to the one that was introduced in the House, or is being circulated in the House by Congressman Gephardt and others.

That approach appears to have generated some support among the United Distribution Companies, the AFL–CIO, the Citizen/Labor Energy Coalition, the National Farmers Organization, the National Council of Senior Citizens, and other groups.

I think that Senator Kassebaum described that proposal to you. And I believe that it has all the trappings of a balanced proconsumer bill that recognizes the limitation of the gas market's ability to self-regulate as well as many of the weaknesses in the present regulatory apparatus.

Such a bill would surely slow, if not reverse, the present gas spiral. My opposition to the administration's proposal is based upon the premise that decontrol of natural gas will only serve to worsen the plight of already hard-hit gas consumers.

The real and immediate winners in a total decontrol scenario are the producers of the old low-cost gas, that gas which is now under permanent controls. The President's bill would decontrol this gas allowing the price perhaps to double or triple, which would in turn create, it is estimated, a $40 billion windfall to the producers of that old gas.

The deregulation of old gas, which comprises more than 60 percent of the gas mix on many of the pipelines which serve the Midwest, will cause a massive transfer of wealth to its producers, and a certain increase in price to its users. A consumer's low-cost cushion will forever be destroyed.

Now it is easy to say that gas producers need inflated decontrolled prices to prop up supply, but it does not stand the challenge of facts. A study on gas producer revenues performed by the Congressional Research Service and commissioned by Senator Exon was released only yesterday.

That study showed that between 1977 and 1981, natural gas revenues to the 26 biggest U.S. energy companies increased from $8.2 billion to $17.8 billion. That is more than double, a $9.6 billion increase.

During the same period of time, supply rose less than 1 percent. Supplies increased little since 1981. The prices to consumers, and no doubt profits to producers, have increased greatly.

It is far too simple to say that the President's natural gas legislation under consideration today raises the question of decontrol. In essence, as I view it, the real question is who controls. When it comes to the natural gas market, I think that it is far better that there be consumer control through prudent Government oversight than complete producer control at the expense of consumers.

And I urge this committee to endorse the concepts that were set forth earlier in testimony from both Senator Kassebaum, Senator Danforth, and now myself.

[The prepared statement of Senator Eagleton follows:]

News from Senator Tom Eagleton

U.S. Senate, Washington 20510 - 202/224-5721

TESTIMONY BY SENATOR THOMAS F. EAGLETON
Prepared for delivery to the
Senate Committee on Energy and Natural Resources

March 10, 1983

AN ALTERNATIVE TO SOARING GAS PRICES

A group of Senators, headed by Senators Kassebaum, Danforth, and myself, are endeavoring to develop a coherent and realistic alternative to the Administration's natural gas deregulation bill. We envision our proposal containing provisions that would freeze gas prices at August 1, 1982 levels until 1987 with a monthly inflation adjustment. We would also tie the price of expensive imported Algerian gas and section 107 deregulated gas to 150 percent of the section 103 "new" gas price; limit take-or-pay contract levels; void all indefinite price escalator formulas; and give pipelines the permanent right to market-out of any contract. We will circulate a description of our proposal to our colleagues next week.

Our initiative will be essentially the same as a proposal that was announced last week in the House of Representatives by a large group of House members. This approach enjoys the endorsement of the United Distribution Companies, the AFL-CIO, the Citizen/Labor Energy Coalition, the National Farmers Organization, the National Council of Senior Citizens, and a large number of other groups representing constituencies which are affected by skyrocketing gas prices.

I believe that this proposal has all the trappings of a balanced, pro-consumer bill that recongnizes the limitations of the gas market's ability to self-regulate, as well as many of the weaknesses in the present regulatory apparatus. Such a bill would surely slow, if not reverse, the present gas price spiral.

My opposition to the Administration bill is based upon the premise that decontrol of the natural gas market will only serve to worsen the plight of already hard-hit gas consumers.

The real and immediate winners in a total decontrol scenario are the producers of "old" low-cost gas -- that gas which is now under permanent controls. The Reagan bill would decontrol this gas, allowing its price to double and triple which would in turn grant an estimated $40 billion windfall to the producers of old gas.

The deregulation of old gas, which comprises more than 60 percent of the gas "mix" on many of the pipelines serving the midwest, will cause a massive transfer of wealth to its producers and a certain increase in price to its users. The consumer's low-cost gas "cushion" will forever be destroyed.

It is easy to say that gas producers need inflated decontrolled prices to prop up supply; but it does not stand the challenge of facts. A study on gas producer revenues performed by the Congressional Research Service and commissioned by Senator Exon was released yesterday. The study showed that between 1977 and 1981 natural gas revenues to the 26 biggest U.S. energy companies increased from $8.2 billion to $17.8 billion -- a $9.6 billion increase. During the same period of time supply rose less than one percent. Supply has increased little since 1981 but prices to consumers and, no doubt, profits to producers have increased greatly.

It is far too simple to say that the Administration's natural gas legislation under consideration today raises the question of decontrol. The real question being raised is who controls.

When it comes to the natural gas market, I think that it is far better that there be consumer control through prudent government oversight than complete producer control at the expense of consumers.

I urge the leadership of this committee to endorse the concepts set forth in the proposal that my colleagues and I will introduce in the coming week.

The CHAIRMAN. Thank you, very much, Senator Eagleton.

Senator EAGLETON. Thank you, Mr. Chairman.

The CHAIRMAN. Are there any questions of the Senator?

Senator FORD. I have no questions.

The CHAIRMAN. Thank you, very much, for being here this morning, and again giving us the benefit of your advice.

I spoke to Senator Specter yesterday, who indicated that he would find it difficult to be here at this hour because of a conflict.

Senator FORD. May I introduce a witness to the committee who will apparently be testifying shortly?

The CHAIRMAN. Surely.

Senator FORD. We are delighted to have you here, and you will make an excellent witness before the committee.

The CHAIRMAN. Thank you, very much, Senator.

When Senator Specter arrives, we will try to accommodate him and his schedule this morning.

The next witness is the U.S. Conference of Mayors represented by the Honorable Richard Berkley, the mayor of Kansas City, Mo., who Senator Eagleton has already introduced to the committee.

Welcome before us, Mayor.

STATEMENT OF HON. RICHARD L. BERKLEY, MAYOR, KANSAS CITY, MO., ON BEHALF OF THE U.S. CONFERENCE OF MAYORS, ACCOMPANIED BY LEN SIMON

Mayor **Berkley**. Thank you, Mr. Chairman.

Mr. Chairman, my name is Dick Berkley. I am the mayor of Kansas City, Mo. I am here this morning representing the U.S. Conference of Mayors, which is composed of the chief elected officials of the Nation's principal cities. I am accompanied by Len Simon, who is with the Conference of Mayors.

I have been concerned, deeply concerned, about the natural gas situation, and have taken the lead within the Mayor's Conference and in other forums in bringing the natural gas policy issue to the forefront of our urban issues.

Mr. Chairman, there is no group of leaders within our society that are more supportive of the marketplace, and least desirous of Federal intrusion than mayors. We draw the line firmly, though, when the marketplace falters, and our people suffer.

That is clearly the case with respect to natural gas. Something has gone wrong, and I am here to offer our assistance.

Natural gas policy has always been controversial. But I can recall no period in my lifetime when its cumulative energy, economic, and human impact hit out cities with such severity.

This is an extremely serious health and economic problem for the people of the cities of this country.

In Kansas City, natural gas prices are one of the most important issues today to all segments of our city. Over the course of the past 4 years, the price of natural gas for residential users has risen at an average of 35 percent compounded each year.

In fact, from January of 1981 until January 1982, the actual increase amounted to 40 percent. Our experience in these past few years supports the fact that gas prices will continue to rise at this high rate if nothing is done to control them.

We have seen gas rise from a cost of a little over $1 per 1,000 cubic feet in January of 1976 to $5 per 1,000 cubic feet at present. Under the present Natural Gas Policy Act, it is estimated that the average home will cost about $500 to heat in 1984, and between $850 and $950 in 1985 after decontrol.

But the raw numbers do not begin to tell the full story. Human suffering is what is truly at stake here. This is a winter that I will not soon forget, because of the real concern and fear that so many people had.

Very fortunately, the last 2 months have been rather mild weather, and some of the very serious situations had at least been delayed.

Nevertheless, our city drew together to raise money for those who needed help in paying skyrocketing gas bills, and for weatherization programs for which the private sector in our community raised and contributed $1.5 million.

It is the winter in which we distributed space heaters to those citizens who could no longer afford the natural gas. Federal policy must respond to this distortion, and as quickly as possible.

There has been no benefit to this uncontrollable, and often unexplainable rise in natural gas prices, except that the faulty nature of the 1978 legislation has been fully revealed, and the combined creativity of the administration and the Congress has brought numerous proposals to the table.

During recent meetings of mayors, it has been clear that the concern over human and economic costs of our existing natural gas policy were widespread, and not simply confined to one region of the country.

We have met on two occasions with the Secretary of Energy Hodel, and he has assumed the reins of leadership of the Department of Energy.

We recognize the attempt that the administration has made to bring in the many complex factors involved in the production and distribution of natural gas. But decontrol, I feel, would be extremely harmful, and I strongly oppose it. The mayors have also worked with many Members of Congress in both the Senate and the other body to attempt to fashion workable proposals.

The Mayor's Conference will adopt a formal position on the many proposals being made at its forthcoming annual conference in Denver. However, based on its recent midwinter meeting, there are some basic principles that I believe most mayors would consider sound.

We hope that these will help guide the committee in its forthcoming deliberations. We urge that this committee restore order, reliability, and predictability to the price structure of natural gas markets. We hope that it will increase competition in both the production and distribution of natural gas, that it will restrict industry practices which create inequitable market pricing impacts on consumers. And that it will bring about an end and reversal to steep gas price increases.

Within the context of these principles, I personally support a repeal of the existing NGPA pricing formulas, a moratorium on natural gas price increase, a price rollback, a reestablishment of price control regulatory measures, and an elimination of indefinite price escalator clauses, and unreasonable take-or-pay provisions from gas production contracts.

I believe from my contact with many other mayors across the country that these positions are reasonable in light of current events. And I will working toward their adoption as the official Conference of Mayors' policy in the coming weeks.

With respect to the administration's proposal, while we appreciate the balance that has been attempted, we find it falls short of actually achieving that balance. The administration moves in the right direction with some areas.

But the centerpiece of its proposal, the decontrol of old gas is likely to cause considerable distress in the cities. Moreover, the administration's proposal does not limit take-or-pay contracts, one of the most significant problem areas that we currently face, but only permits them to be renegotiated.

The administration would continue to allot automatic passthroughs, and generally places far too much authority in the Federal Energy Regulatory Commission, which has displayed dubious ability to protect customers in this area to date in our view.

Several other proposals have considerably more merit, in my view. Senators Tom Eagleton and Jack Danforth of Missouri have cosponsored their own legislation, which calls for a 2-year freeze in gas policies at the wellhead, nullification of certain contract provisions, and an extension of the NGPA price levels through 1987.

Very recently, Congressman Richard Gephardt, along with a number of his colleagues, had proposed the Natural Gas Consumer Relief Act, which has as its main elements provisions which would lower prices, solve the contracts problems, improve pipelines' purchasing practices, and guard against FERC practices to increase prices.

It is an excellent and well-balanced approach which has garnered enormous support in a very short time, and we recommend it for your consideration.

Mr. Chairman, as this committee moves forward with its important work, the U.S. Conference of Mayors, pledges its cooperation, and urges that the committee seek a solution which can guarantee to the millions of city residents and businesses a stable and workable natural gas policy, which provides an adequate rate of return to the producer and distributor, but does not burden the consumers in our cities with price shocks and uncertainty.

Thank you, on behalf of all the mayors for listening to our views this morning. We look forward to working with you in the coming weeks. I would certainly be pleased to answer any questions that the committee may have.

The CHAIRMAN. Thank you, very much, Mayor.

Senator Johnston.

Senator JOHNSTON. Mayor, I am looking at a Bureau of Labor Statistics figure here on the city of Kansas City as compared to other cities. And I find that as of this date, which is as of October 1982, it shows that Kansas City has an average price of $4.68 per Mcf.

Is that correct?

Mayor BERKLEY. That is correct. It is approaching $5, and will be there momentarily.

Senator JOHNSTON. Right. And this shows that this is the cheapest of any of these major cities shown in these statistics other than Anchorage, Alaska, and Miami, Fla.

Are you aware that you are one of the the cheapest?

Mayor BERKLEY. Yes, we are fortunate. Our escalation rate has been higher than others, because we started with a lower base. But the concern is a very extreme one. Because the percentage increases have in fact over the last several years been higher than most other cities.

But I am here not only representing Kansas City, but for the most part representing the U.S. Conference of Mayors. And it is an extremely serious problem throughout the country.

Senator JOHNSTON. I understand that. But you referred to Kansas City, and the hardship in Kansas City. And I want to followup on that. So we have established that Kansas City has one of the cheapest gas prices in the country.

Are you also aware that Kansas City—the alternate fuel oil, I guess, would be No. 2 fuel oil—that your natural gas price in Kansas City is a percent of No. 2 fuel oil would be something less than 60 percent on a Btu basis?

Mayor BERKLEY. Yes.

Senator JOHNSTON. Now if you are one of the cheapest cities in the country, and you are 60 percent of No. 2, which is the fuel used in the rest of the country, what would be a fair price in Kansas City or elsewhere?

Mayor BERKLEY. Well, that would be hard for me to determine what a fair price would be. But we are seeing a process that has been going on for the last several years, not only in Kansas City, but across the country, that is in fact creating great hardship.

And the fact that it is escalating so quickly at a time when we know that there is relatively cheap gas available in the ground—and in our area, there happens to be some in the western part of Kansas, not many miles away that would be a much lower price—and, of course, the take-or-pay contracts are causing a severe increase in the total price that the consumer pays without the benefit of using that gas.

Senator JOHNSTON. Mayor, you are aware that about 50 percent of the rigs in American are now stacked; are you not?

Mayor BERKLEY. Correct.

Senator JOHNSTON. Now you advocated a return to price controls. I assume that if prices are too high now, you would want to roll those prices back?

Mayor BERKLEY. There is legislation proposed by the Senators Eagleton and Danforth that I think rolls it back to August. And Congressman Gephardt's bill will roll it back to the beginning of 1982.

Senator JOHNSTON. If half of the rigs in America are stacked now, and you are going to roll the price back, what effect would that have on those rigs that are stacked, an increase or a decrease?

Mayor BERKLEY. Well, the sad part is now that we have continuously increasing prices at this time, and we know that this has caused a significant decrease in the demand. I am told that about one-third of the demand has been reduced as a result of these escalating prices.

So we seen some reduction in the price structure when the demand is down. But that has not occurred.

Senator JOHNSTON. Well, as I say, if you roll the price back, is it not logical to expect that there is less incentive, so that the number of rigs stacked would not decrease, but would increase?

Mayor BERKLEY. That is correct. But there is less need for the gas. That is the situation at the moment, where we see significantly lesser requirements for gas because of the escalating rates. And consequently, the price should begin to drop, but it has not been.

Senator JOHNSTON. Would you agree with me, Mayor, and our projections, which would show that while the demand for gas is down at the present time, that that demand will be up sharply when we go back into recovery.

And we are told and the statistics indicate that there is a recovery. After all, we have over 30 percent of our industrial base presently idle.

As we go back into a recovery, and the need for gas comes up, that that surplus in natural gas which we now have will disappear.

You would agree with that, would you not?

Mayor BERKLEY. I am not familiar enough to say that it would disappear. It would certainly be reduced. But when you have had a

30-percent reduction also in the consumption, I doubt that it would all be reduced.

Senator JOHNSTON. Well, Mayor, would you not agree with me that it would be particularly unwise to reduce incentive when we have half the rigs stacked, when we can clearly project an end to this surplus, and when the alternate fuels are all more expensive. No. 2, No. 6 fuel oil is more expensive. Canadian natural gas is $5. That is $5 as it crosses the border, and not at the city gate. Mexican would be more expensive.

Does it not serve us well to develop our own resources here in the United States?

Mayor BERKLEY. Well, I certainly agree with developing our own resources. But at the same time, we are seeing two things happen. The weatherization programs, both those that are funded in part or in whole by various levels of government, and those being assisted as we do in Kansas City with private contributions as well as individual homeowners, are in fact having a signficant impact on the need from the residential dimension.

And we are seeing in certain areas, depending on the relative price of oil or oil related products, we are seeing some switching in the business sector from natural gas to oil. There is much more flexibility, as you know, in the ability of a business to alternate back and forth, where the residential homeowner is actually unable to do that.

In our community, 95 percent of the homes use natural gas. And we basically only have one pipeline coming into the city. So there is no ability from a competitive standpoint, and there is no ability to pick alternate sources.

So I personally feel that while we must maintain a reasonable level of capacity in this country, we in fact do have some switching away from natural gas, some of which will be permanent. Because as new homes are being built with better controls, and less use, and less wastage, and whatever, I think that that level of demand at least in the residential area will remain down.

Senator JOHNSTON. Let me say that I share your concern about higher prices. I also have a great concern about supply. We want to balance those two. And those of us on this committee will certainly work with you to get as low a price as we can consistent with a good supply.

Thank you, very much.

Mayor BERKLEY. Thank you, Senator.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No questions.

The CHAIRMAN. Senator Ford.

Senator FORD. Mayor, I finally heard you mention a number. We have heard nothing but No. 2, and the cost of No. 2. And finally I heard the distinguished Senator from Louisiana mention No. 6.

What does No. 6 cost in your general area?

Mayor BERKLEY. I do not have that figure.

Senator FORD. It would be somewhat lower?

Mayor BERKLEY. Yes; I would think that it would be.

Senator FORD. Well, EIE calculates an average No. 6 price for incremental pricing purposes as $3.32, I believe, per Mcf in October, and $3.69 in November. And I believe in January, it was about $3.95. So that No. 6 is somewhat lower than your average price.

Mayor Berkley. Correct.

Senator Ford. So am I correct then that Kansas City competes with No. 6 rather than No. 2?

Mayor Berkley. Yes.

Senator Ford. So if No. 6 is going to be somewhat lower than natural gas, that would be the price that you would be looking at, like $3.95 rather than $4.68, and soon to be $5.

Mayor Berkley. Right.

Senator Ford. We are looking at a dollar less now going in per mcf in natural gas in competition with No. 6. It is strange for me to understand that when you have 50 percent of the rigs idle, and prices seem to accelerate to a point where people cannot pay, and the economic times dictate that basically, and we have a projection from this administration that I think throughout 1984 we are going to see somewhere in the neighborhood of 9 and 9.5 unemployment.

So it is not something that is coming down overnight, and something that we can look forward to a lot of people going back to work. We are talking about a 1-percentage-point reduction in a period of now roughly 24 months. There are no prospects out there of being able to pay for higher energy costs.

And we are hearing this morning that what we want to do is to have a need for more natural gas, so that we can get more wells out, and find more. And the incentive so far has been price. And if you cannot get a better price, there is not incentive to go look for it.

Mayor Berkley. Right.

Senator Ford. So it seems to me that if we look realistically at the proposal, that if you deregulate, you are going to get more money. There is also the other side of that coin. If you deregulate old gas, you do not have to look for it, because you have plenty of windfall for a long period of time.

Do you agree with that?

Mayor Berkley. Well, it depends on how you define windfall. If you are talking about that in fact it would be available, because we know that it is in the ground, and we know that it would be less expensive, yes.

Senator Ford. I am talking about the old gas that is now being deregulated under the administration plan.

Mayor Berkley. I would be opposed to that, because I think that that would just mean that that much more would go into the large producers, or the small producers as well. I think that we do need to find a way of getting that old low-cost gas getting into the system in greater numbers.

Because I think that it is a tragedy that we find individual homeowners, who are so severely adversely affected, that their own home budgets are at the last end of the possibility, because of the extremely high prices.

And yet we know, in fact, that there is low-cost gas available, and it should be more into the system.

Senator Ford. Mayor, during the period prior to 1977 when we were experiencing gas shortages, and my colleague on my left from Ohio, as many as 200,000 of his people were put out of work because of natural gas shortages, I think that one of the main things that we were able to do in that piece of legislation was move intrastate into interstate, so that the consumer States would have an opportunity to have the benefit of this additional gas.

But you had to be quid pro quo as far as price to get it into the interstate pipeline.

During that period of time what kind of shortage did Kansas City have, and were you intrastate or interstate served?

Mayor **Berkley**. We were in fact having some degree of shortage, not of major magnitude. But again, we recognized and we realized that we needed to put the legislation in perspective, that there were some concerns about shortage. I think that what really bothers us is that there is not a bigger ability to anticipate and project what in fact would happen with that legislation over any extended period of time.

I realize that none of us can forecast with any great degree of accuracy. But it seems to me that there should have been a much greater ability to recognize that there would be compounding rates of 35 and 40 percent a year. And some mechanism should have been developed, so that we would not go from some potential shortage to an overabundance, and prices that have escalated in the range of 300 to 400 percent in a very short period of time.

Senator **Ford**. We have a different situation here. We were encouraging them to look for additional supplies. And on top of that, we find an unemployment figure, and that 30 percent of our industrial base is not being used. So that is one of the problems.

You are familiar with the Kansas City 1976 and 1977 winter?

Mayor **Berkley**. Yes.

Senator **Ford**. Were any factories affected in your community as related to shortages?

Mayor **Berkley**. Did you say factories, sir?

Senator **Ford**. Yes. Manufacturing, industrial complexes.

Mayor **Berkley**. I was not mayor at that time. But I would imagine that there were a few that had some modest impact. But I do not recall anything of any severity.

Senator **Ford**. If your constituents had to choose between an adequate supply of natural gas and higher prices, or a shortage and factory closings coupled with lower prices, what would they chose?

Mayor **Berkley**. Well, I do not think that it is necessary to have that choice presented to them. I cannot believe——

Senator **Ford**. You answered my question well.

Mayor **Berkley**. I cannot believe that with our abilities in economic analysis, with our knowledge of the potential gas that is available, that is already discovered, with our knowledge of what the projected usage should be, and with the factors such as weatherization that are going on in fact with the residential consumption, that we cannot reach some kind of middle ground that does in fact provide for enough incentive for the producers to generate the adequate amount of gas production, and at the same time keep the pricing at a reasonable rate.

I think that people are willing to pay, and it is hard to say what is precisely reasonable. But when they see their rates going up 35 and 40 percent a year on a compounded basis, and see it going from as I mentioned approximately $1 to $5 per 1,000 cubic feet in a 6-

year period, that just does not make sense to them, and quite frankly to me, that that is necessary.

I know of virtually no other product in this country where that has happened.

Senator **Ford**. Mayor, do you support, or continue to support State regulation of local gas distribution companies?

Mayor **Berkley**. Yes, we do have——

Senator **Ford**. I said do you support the continuation of it?

Mayor **Berkley**. Yes.

Senator **Ford**. What we find, and I brought it out yesterday, is that there is restraint on transmission lines under the present legislation. There is a restraint on distribution systems by State public service commissions. But there is no restraint on the producer, as we get to this, and what is fair and reasonable in the gas price.

I have never found a spot market for natural gas. Coal and oil, you can find that. And I was told yesterday by Secretary Hodel that with his legislation, we would have a spot market in natural gas. If you got in trouble, you would just reach out there and get it.

What I am hearing now is 50 percent of the rigs are down, and nobody is looking for natural gas. So I am not sure we have a spot market.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator.

Senator Metzenbaum.

Senator **Metzenbaum**. I came in late, Mr. Mayor, but I read your statement. I do not have too much to disagree with. Thank you, for appearing.

The **Chairman**. Mayor Berkley, I know that in a complex subject, we tend in order to communicate well to simplify the statement. And in doing so, we also run the risk of becoming less than totally accurate. That plagues all of us who know how to communicate, and want be totally accurate at the same time.

I am looking at page 4 of your statement, and your characterization of the administration proposal at the bottom of the page. It says, "the administration does not limit take-or-pay contracts."

Are you referring to price, or quantity, or did you intend to make that an absolute statement?

Mayor **Berkley**. Well, I realize that it does provide some variation down to, I think, 70 percent. But after the third year, if my memory is correct, it would no longer have any limitation. So I think that technically, I would have to agree with you, Mr. Chairman, that that should have a slight modification.

But I think that the degree of impact is relatively minor.

The **Chairman**. And again, in the next sentence you say, "the administration would continue to allow automatic passthroughs."

Is that intended to be a technically accurate statement, or a characterization of the proposal?

Mayor **Berkley**. Well, I think that it is generally a characterization. I realize that in the bill there are some changes that would have some modest impact. But I think that our concern has been the historical, in which I think for the most part would continue.

That in fact, FERC has been passing through virtually everything. And in fact, it has even added some situations beyond that.

And that is our concern, that it really needs to have a thrust that causes the pipeline companies to have more pressure put on them to in fact attempt to buy cheaper gas.

There is really very little incentive for them to buy anything but the higher price gas. And that was the reason in the take or pays, that they signed these long contracts.

The CHAIRMAN. I do not mean to be a defender of FERC in all of this. But I think that it is fair to point out that much of the automatic passthrough that they are blamed for is required by a law that Congress passed.

Mayor BERKLEY. Right.

The CHAIRMAN. Thank you very much.

Mayor BERKLEY. Thank you, Mr. Chairman. I appreciate it.

The CHAIRMAN. Thank you very much for your testimony.

We will next hear from a panel composed of Mr. Howard Marlow, associate director of AFL-CIO; Mr. Robert M. Brandon, executive director of Citizen/Labor Energy Coalition,. Dr. Mark Cooper, Consumer Energy Council of America; and Mr. David I Greenberg, legislative director of the Consumer Federation of America.

If you gentlemen would please take your seats.

I would like to note for the record at this point that we have your prepared statements. Those prepared statements will be made a part of the record in full, and particularly with respect to the Citizen/Labor Energy Coalition and the Consumer Energy Council of America, who have filed lengthy, detailed, and exhaustive statements.

I would invite you to summarize those statements rather than to give all of them, because we don't have enough time to proceed to the questioning that will assist us as well.

With that, we will hear from Mr. Marlowe first.

STATEMENT OF HOWARD MARLOWE, ASSOCIATE DIRECTOR, AFL-CIO

Mr. MARLOWE. Thank you very much, Mr. Chairman,

The AFL certainly appreciates this opportunity to submit our views on natural gas pricing legislation to this committee.

As you requested, I will summarize our prepared statement.

The AFL-CIO is concerned about natural gas regulation because of the severe hardship that rising natural gas prices have imposed on American households. Skyrocketing gas prices have already caused families to choose between heating their homes and putting food on the table.

Tens of thousands of individual households are without heat during this mild winter because they have had to make the choice between paying the fuel bill and paying the rent or mortgage.

Every natural gas consumer in the country is a captive consumer. They cannot shop around for the gas utility that offers them the lowest price. They have only one choice, and they must pay whatever that utility charges or go without heat.

Nor does the utility have much choice. It must pay the price charged by the gas pipeline, and many pipelines are forced to pay whatever the producer charges.

Clearly, this is not a free market situation. That is why the Government must maintain an active role in setting price ceilings and policing contract terms.

The Natural Gas Policy Act, however, called for phased price deregulation of new natural gas. Since its passage, residential gas bills have more than doubled.

Even if nothing is done to that agony, residential gas bills will increase by another 55 percent over the next 4 years.

What is most troubling is the fact that these massive gas price increases are occurring in the midst of a gas supply glut. Even the monopolistic oil industry is experiencing declining prices in the midst of an oil glut, but not so for natural gas.

This stands as stark testimony for the nonexistence of anything approaching a free market in the gas industry, and the need for the Government to increase its regulation of gas.

Those who suffer the most from high gas prices are those who can afford it least. There are millions of unemployed Americans during this recession. They look to Congress for gas price relief.

The elderly and the poor—they, too, look to Congress for gas price relief; and the thousands of farmers and small businesses who depend upon natural gas are looking to Congress for gas price relief.

Natural gas is such a vital component of our major industries and of our food production that it is safe to predict that our economic recovery will be further slowed, if not denied, unless Congress places restraints on natural gas prices.

More than 20 million Americans work in industries and businesses that depend on natural gas. These businesses cannot expand if fuel prices go higher.

In fact, some may be forced to lay off workers, or to close their doors. The problem of ever-rising gas prices is a nationwide problem that affects all sectors of our society and of our economy, and the only source of relief can come from Congress.

Clearly, the administration will offer no relief because their proposal is little more than a plan to deregulate all natural gas, even the so-called old gas that Congress years ago decided to remain under price control.

They ask American consumers to trust the free market, and the Federal Energy Regulatory Commission.

But there is no free market, and FERC has already made it crystal clear that it won't do anything to hold down gas prices.

In fact, it is FERC that has misused the Natural Gas Policy Act to allow prices to rise far beyond any just and reasonable levels, far beyond the levels envisioned by Congress 6 years ago.

Mr. Chairman, there has been good discussion prior to my appearance here this morning before this committee about the details of the administration's proposal.

Let me just say that, in summary, that proposal offers the American consumers the prospect of more rapid increase in natural gas prices than is scheduled under current law.

Clearly, Congress should adopt an alternative approach that offers consumers the prospect of relief from spiraling natural gas prices.

That natural gas price relief alternative should roll back price ceilings. Since these ceilings are also interpreted by the industry as the price floor, a rollback will provide American consumers with immediate relief.

The price of natural gas has far outstripped increases in the rate of inflation and the price of oil. It makes sense to roll back the natural gas price ceilings.

Effective limitations must be placed on "take-or-pay" contracts. Pipeline rates should be reviewed by FERC to assure they are just and reasonable, and all pipelines contracts should be filed with FERC and made available with the public.

Indefinite escalator clauses and other inflational contract provisions should be eliminated, and FERC must be told to place reasonable limits on the various types of high-cost gas that come under section 107 of the Natural Gas Policy Act.

Some of this gas now sounds at an unbelievable rate of $10 per thousand cubic feet.

It is equally essential that Congress extend controls on new natural gas beyond their scheduled expiration date of 1985, and that they continue price regulation of old gas indefinitely as envisioned by the Natural Gas Policy Act.

There is an imperative need for the Federal Government to regulate natural gas prices, and that need will not expire in 1985.

These are some of the essential elements of natural gas consumer relief.

The AFL-CIO urges Congress to reject any and all proposals that would decontrol prices of natural gas and to adopt legislation that will provide consumers with relief from the already-excessive price of natural gas.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Marlowe follows:]

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TESTIMONY OF HOWARD MARLOWE, ASSOCIATE DIRECTOR AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE SENATE COMMITTEE ON ENERGY & NATURAL RESOURCES ON NATURAL GAS PRICING LEGISLATION

March 10, 1983

The AFL-CIO is concerned about natural gas regulation because of the severe hardship that rising natural gas prices have imposed on American households. More reasonable natural gas prices and effective restraints on price increases are vital to the welfare of the public and the health of the American economy.

We urge Congress to provide needed relief from high prices by rolling back prices, extending price controls, rejecting any accelerated phaseout of controls prohibiting unjust "take-or-pay" contract provisions, and preventing the Federal Energy Regulatory Commission from taking unjustified administrative steps to increase gas prices.

The AFL-CIO strongly opposes the Administration's natural gas proposal which would be much more harmful than continuing the present course under the Natural Gas Policy Act. Under the Administration's proposal, all natural gas would be deregulated and natural gas producers would be free to use their monopoly power to withhold natural gas from consumers.

The Administration's proposal would deregulate all gas on January 1, 1985, including old gas which would otherwise continue to be controlled under current law. Until that time new contracts would be negotiated on their own terms and old contracts could be renegotiated. The average price negotiated is referred to as the "gas cap".

While it is unlikely that contracts would be negotiated at a lower price, the greater power of gas producers could result in some contracts being negotiated at a higher price. Thus, we see no problems being solved by this provision, only an upward trend in prices.

The "gas cap" would apply to old gas when contracts expire on January 1, 1985 until January 1, 1986. This "gas cap" will be unnecessarily high and will provide little, if any, moderation in the explosion of gas prices expected on January 1, 1985 as producers rush to raise prices.

The monopoly power of producers and pipelines make it impossible to rely on private negotiations to set natural gas prices. Perhaps it would be more defensible if natural gas production were less concentrated and if the millions of Americans who rely on natural gas for warmth in the winter could enter into private negotiations with gas producers. Of course, this is impractical. That is the very reason for the need to continue regulation of natural gas. Without price controls, consumers are at the mercy of the monopoly power of natural gas producers and pipelines. It is the responsibility of the federal government in this situation to protect the welfare of the public by recognizing the natural gas industry as a public utility. Such a responsibility requires regulation of the gas industry to provide "just and reasonable" prices based on the cost of production and to ensure the delivery of an adequate supply of natural gas to consumers.

There is no justification for the Administration's proposal to decontrol old natural gas which would otherwise remain under control after 1985 under current law. Old gas accounts will account for about 40 percent of gas sold in 1985 and now is sold to pipelines for about $1.38 per thousand cubic feet.

It comes from wells producing before 1977. In most cases, drilling and exploration costs for these wells should have already been recovered and the gas can be produced profitably at very low prices. The President's proposal would cause the price of old gas to rise more than 2½ times the current average price of old gas. Producers would be able to raise prices even if the gas is under contract because the Administration's bill would permit them to break every contract on January 1, 1985. A massive price shock is likely to occur as producers rush to raise prices on that date.

In summary, the Administration's proposal offers American consumers the prospect of a more rapid natural gas price increase than scheduled under current law. Clearly, Congress should adopt an alternative approach that offers consumers the prospect of relief from spiraling natural gas prices.

The first element of gas price relief should be a rollback of price ceilings. Current law has allowed gas prices to escalate far more than is justified and far more than Congress envisioned in 1977. A rollback to levels that existed at the beginning of 1982 will eliminate some of the harsh effects of high gas prices on American consumers. Similarly, reasonable limits should be placed on the high-cost gas that presently comes under Section 107 of the Natural Gas Policy Act, and now sells for as much as $10 per thousand cubic feet. The FERC has not exercised prudent judgment in allowing price increases for this gas, which is another upward force on the price of all natural gas. In addition, to assure restraint on gas prices, Congress should extend controls on new natural gas beyond the scheduled January 1, 1985 expiration date. Without this protection, about 60 percent of all natural gas will--under current law--be without price controls in 1985. Extending the controls together with other measures would prevent a price explosion and guarantee restraint for a reasonable period, giving Congress time to assess what further measures should be taken.

The excessive prices caused by "take-or-pay" contract provisions which now force pipelines to buy high-cost gas even when lower-priced gas is available should be addressed. Many contracts also include indefinite price escalators which would drive gas prices to higher levels far into the future. To alleviate this problem, take-or-pay obligations should be justly limited so that pipelines can take advantage of lower-priced gas. The President's proposal to impose a 70 percent limitation on "take-or-pay contracts will not provide consumers with the price relief they need. The Presidnet's proposal to impose a 70 percent limitation on "take-or-pay" contracts will not provide consumers with the price relief they need. In addition, any contract provision that links the price of natural gas to any other fuel or commodity should be voided.

The Federal Energy Regulatory Commission must have the responsibility to review and approve contracts between gas producers and pipelines and to review pipeline rate filings and pass-throughs of pipeline costs to assure that they are just and reasonable.

And Congress should provide FERC with a clear policy directive that discretionary administration authority cannot be used to raise gas prices above the ceilings established by Congress. The use of this discretionary authority by FERC in the past has amounted to little more than backdoor decontrol.

The AFL-CIO urges Congress to reject any and all proposals that would decontrol gas prices and to adopt legislation that will provide consumers with relief from the already-excessive price of natural gas.

The CHAIRMAN. We will next hear from Mr. Robert M. Brandon, Citizen/Labor Energy Coalition.

Mr. Brandon, I hope you can summarize your statement and limit your remarks so we can hear from the rest of the witnesses this morning.

Mr. BRANDON. I will.

STATEMENT OF ROBERT M. BRANDON, EXECUTIVE DIRECTOR, CITIZEN/LABOR ENERGY COALITION

Mr. BRANDON. Thank you, Mr. Chairman, and members of the committee.

I want to run through quickly—first of all, let me say that we have done a study of what would happen if Congress did nothing at all in terms of natural gas prices, and I would like to see if we could make that part of the record.

Essentially, this study concludes that a price increase of residential heating bills of 55 percent over the 4 years under the present law.

Our study also indicates that under accelerated control that increase would rise to almost 70 percent. We believe that something needs to be done. Let me first say that I think that the President also recognized that.

Secretary Hodel has made an eloquent case for why Government needs to get involved in bringing prices down from today's unacceptably high level.

Unfortunately, their legislation does not reflect the rhetoric. The President's bill would, in fact, increase prices even further, and also jeopardize stable supplies in the future.

Senator METZENBAUM. Mr. Chairman, I would ask unanimous consent that that study be made a part of the record.

The CHAIRMAN. It will be made a part of the record. Is that the one you have there?

Mr. BRANDON. Yes.

The CHAIRMAN. Yes, it will be made a part of the record following your statement.

Mr. BRANDON. Thank you.

Before I go on to expand on the reasons why the President's plan, we feel, does not provide the kind of relief that is necessary, let me just quickly outline the reasons that we feel we are in the present situation that we are.

Today, the price ceilings have really become floors, that under normal market conditions, if there was a free market where consumers and industry could signal back up to producers that the price they are charging is too high to be affordable, then prices would come down in a period of glut.

The fact that producers are able to sustain prices for their gas at the ceilings levels under the NGPA, rather than making their gas available for less than ceiling seems to indicate, one, that there is a lack of competition, and, two, that the ceilings are the only thing keeping prices down today.

Unfortunately, those ceilings are increasing at too rapid a rate. The NGPA ceilings are increasing at inflation plus 4 percent. That is why, since the NGPA was enacted, prices have jumped 100 percent in terms of residential heating bills from natural gas.

In addition to that, the lack of competition with the pipelines, vis-a-vis, the producers, means that they can't bargain down those prices themselves.

An example evidence of this really is the kinds of contract clauses they have agreed to in the past, and the fact that the renegotiation to the extent that it is going on at all today is not affecting the price of the downward direction.

The pipeline clauses that have been agreed to in terms of most notably the high "take-or-pay" requirements, an indefinite price escalators, and in fact in many cases the pipelines, abrogation of their own right to challenge in court what a producer says the price should be under the contract—all point to the fact that there is little leverage on the pipelines, part to bring prices down in a period of glut, even when they can't sell their gas in the markets they have.

Third, this pipeline accountability problem is exacerbated by the fact that pipelines are almost guaranteed automatic passthroughs for their purposes, in spite of the fact that many of them are imprudent, buying expensive gas when cheaper gas is available.

The result of these last two points is that more and more high cost new gas is being pushed on to the marketplace, replacing cheaper old gas that would be available if pipeline contracts did not require high-cost gas to be delivered.

As we all know, those high costs of the pipelines get automatically passed on to the utility company level, to the ultimate consumer and industry.

And, finally, the fourth point is that FERC has overseen this situation and has allowed prices to increase, even when we believe they have the authority to have done something about the contract situation; and in addition to that, FERC has taken actions on their own to raise prices which I enumerate in our testimony.

Quickly on the Reagan plan itself—first of all, the centerpiece of the plan really is to decontrol gas prices, most notably old gas prices.

We believe that the cap that is referred to is really going to act as a cap kind of cork in a bathtub effect, because the cap is simply going to be determined by all the new gas contracts that are renegotiated under this decontrolled environment.

There is very little incentive for any producer with low cost gas to sign a contract at low prices because if they hold on to their gas until January 1, 1985, they can unilaterally abrogate their contracts and sell that gas for the higher decontrolled price.

In addition, any renegotiated contract would be on the basis of decontrolled gas.

The other major point in the President's plan that the chairman referred to earlier—the "take-or-pay" requirements are not mandatory; they are voluntary in terms of reducing take-or-pays down to the 70-percent level. Many people feel that is inadequate to make a dent in the enormous problem now of high-cost gas being pushed onto the market when as much as 3 trillion feet of low-cost gas is remaining shut in.

The President's plan also does nothing about indefinite price escalators. In fact, indefinite price escalators are allowed to operate after January 1, 1986. The only limits on them before then really are what FERC might do in terms of automatic passthroughs.

And on that point, finally, the President's plan provides inadequate protection of passthroughs. It talks about limiting passthroughs to inflation, but in fact, first of all, it cannot act to limit passthroughs below the inflation rate, the way I read the law.

Second, FERC could act to increase prices above inflation through some sort of modified hearing procedure, and it would seem to me that a pipeline who comes in and says: "We have just bought gas at your cap. Your new gas decontrolled cap."—would have a strong argument to argue that this was a prudent purchase and should be allowed to pass through, and we would expect that FERC, given its track record, would approve those increases and those requests, even if they are above the inflation rate.

And, finally, FERC's authority to review PGA's above the inflation rate is only temporary, lasting until January 1986, and we believe that, in summary, then, the President's plan is really long on decontrol, short on consumer protection.

Consumer protection items in the plan are either temporary or they are illusory.

On the other hand, we would support the proposal that recognizes that the market is not a free market when consumers have no opportunity to shop around for the cheapest gas, when utilities have no opportunity to shop around for the cheaper gas, and when pipelines are confronted with the reserve requirements to make them negotiate primarily with the major producers who have a great deal of market power in the situation.

That we must move to a situation where prices should be lowered by moving price ceilings down to a level that would more accurately reflect what they would be if consumers and industrial customers could signal to pipeline producers that the gas prices they are charging are too expensive.

We also believe there needs to be a cap on high-cost gas and Algerian gas in elimination of the indefinite price escalators, and statutorily limits of 50 percent placed on "take-or-pay" requirements.

Also, a requirement that FERC review PGA, based on a standard that more involves prudence and just and reasonable contracts that are in the public interest; and finally, we believe that the authority that FERC has threatened to use to raise old gas prices administratively should be repealed and the authority to add new categories of high-cost gas should also be limited.

And I will stop there, Mr. Chairman.

[The prepared statement and study submitted by Mr. Brandon follows:]

STATEMENT OF

ROBERT M. BRANDON,
EXECUTIVE DIRECTOR

CITIZEN/LABOR ENERGY COALITION

Mr. Chairman and Members of the Committee:

My name is Robert M. Brandon. I am Executive Director of the Citizen/Labor Energy Coalition. The Coalition is a nationwide organization which represents over 300 labor, community, church, farm and senior citizen groups. I want to thank you for the opportunity to testify at these hearings on how to protect consumers from the pain and devastation being created by rising natural gas prices.

As the Committee knows from its hearing last December, millions of gas-using Americans are facing a crisis. Since enactment of the Natural Gas Policy Act in 1978, wellhead natural gas prices have tripled and residential gas bills have more than doubled. This winter alone, prices have shot up 25% on average, with some regions experiencing increases of 50% or 60%, despite the current glut of gas.

Natural gas prices quite simply have become unaffordable for many Americans to use in their homes, businesses, churches, farms or schools. The problem is particularly acute for those who have little opportunity to switch to other fuels because of insurmountable front-end costs or for those who have already taken every conservation opportunity open to them. The Energy Coalition, in past studies submitted to this Committee, estimated that 300,000 gas-heating households will be disconnected this winter because they can no longer afford to pay their gas bills. As winter shut-off moratoria end this month, many more will be disconnected and will have great difficulty being reconnected before the start of next year's heating season. According to a study just released by the National Consumer Law Center, individuals in 41 states receiving the maximum Supplemental Security Income benefits will have less than $50 left each week this winter after paying their energy bills. Those dependent on unemployment benefits will have less than $75 left each week. Those meager amounts obviously are inadequate to pay for housing, food, medicine and other essential needs.

It is no longer just low-income households who are affected by soaring gas bills. The new poor, the unemployed, the working family, the farmer or small business-person trying to stay afloat are increasingly jeopardized by the unending spiral of fuel bills. Since the NGPA was enacted, wellhead natural gas prices have added $14 billion to industry's annual gas bill and $4 billion to the costs paid by small commercial establishments. The sixty percent of the nation's grade schools which depend on natural gas are finding that high gas bills erode public school budgets for teachers, books and other educational materials. Agricultural users who have no substitute fuel for fertilizer, irrigation or crop drying are being squeezed and confronted with the possibility of farm foreclosure.

There is an immediate and dire need to reverse this pattern and make natural gas affordable to the millions who depend on it for home use and business activity. In the attached report, "Gas Prices Out of Control: The Cost of Inaction," The Coalition found that maintaining the status quo -- the Natural Gas Policy Act -- would raise wellhead prices by 70% over the next four years and residential bills by 55%. For those gas users desperately crying out for relief from today's high prices, any additional increases cannot be tolerated and must not be allowed.

There appears to be widespread agreement that some measure must be enacted to address the natural gas crisis. But it is essential that whatever legislation is passed solve the problems in the gas market. Solutions which only promise price reductions or proposals which would exacerbate the situation by raising prices even higher must be rejected in favor of a comprehensive approach that will provide the certainty of lower fuel bills. Failure to do so would be a cruel hoax on gas users looking to Congress for assistancee.

I. Causes of the Gas Problem

Before discussing why the Energy Coalition believes the Administration bill fails to provide consumer protection and why the approach we prefer would give assurance of lower prices, I would like to outline briefly the causes of unjustifiably high gas prices. It will then be easier to explain the deficiencies in the Administration's proposal and the benefits of the solution endorsed by the Coalition.

Ceiling Prices. When the Natural Gas Policy Act was enacted in 1978, it established a set of ceiling prices that were intended to limit increases but to allow contract prices to be set at levels below that ceiling. It was not intended that the ceilings would act as Federally-approved rates which required that consumers pay the highest allowed price as a matter of course. In many discussions of the gas problem, it has been made to appear as if producers are forced to charge prices in excess of market-clearing levels because of the ceiling provisions in the NGPA. This is not the case. Producers have full discretion to price gas far below ceiling levels in order to meet market conditions. Their failure to use that discretion and insistence on pricing gas at the highest possible level means that even in the face of falling oil prices and demand for gas prices have continued to adhere to the highest allowable ceiling levels. This suggests that ceiling prices should be lowered, not that all restraints should be removed as in the Administration proposal.

Contract Provisions. The second major cause of today's high gas prices is the existence of contract provisions which lock pipelines into paying for high-priced gas when cheaper supplies are available. The take-or-pay clause is a major contributor to the problem and is prime evidence of the inability of pipelines to act as tough negotiators on behalf of consumers.

The market dominance of natural gas producers can also be seen in the fact that virtually every producer/pipeline contract signed since passage of the NGPA contains an indefinite price escalator provision that would raise deregulated gas prices above market-clearing levels. The most onerous provisions are those that tie wellhead natural gas prices to levels as high as 120% of the price of No.2 heating oil and most-favored nation clauses, which require a buyer to pay the highest price paid by any subsequent purchaser in the same geographic area.

Lack of Competition in the Gas Market. Despite the overwhelming need to limit take-or-pay provisions and eliminate indefinite escalator clauses, it would be a serious mistake to overlook the reason why those contract provisions were adopted to in the first place. The fact that pipelines agreed to rewrite pre-NGPA contracts at higher NGPA prices, their acceptance of onerous contract provisions, and their acquiescence in purchasing high-cost gas in order to obtain old gas supplies illustrates the ability of producers to use their market power at the expense of pipelines and their customers, both local distribution companies and end users. It is important to underline the lack of market clout utilities and consumers have in the gas system. Consumers can buy gas from only one source. That source -- the local utility -- in turn can buy gas from only one or two pipelines. Thus, utilities and ratepayers must look to pipelines to act as their bargaining agents with producers.

In the past, pipelines concerned more about supply than price have not negotiated well on behalf of consumers. The evidence is that even with today's supply glut, pipelines are still not acting to take advantage of the temporary shift from a seller's to a buyer's market. Voluntary renegotiations have been slow and ineffective in lowering gas prices. To assume that pipelines will be able to transform themselves into tough negotiators, to cast aside years of psychological dependence on producers, and to put aside any affiliated interests in production companies is to rest the hope for consumer relief on a very shaky foundation indeed. More dependable means for restoring some balance in the market must be included in any legislation that will solve the current gas crisis.

Automatic Pass-throughs. FERC has maintained a strategy of failing to act on its authority to limit unreasonable price increases. By interpreting its Section (601)(c) authorities regarding the "fraud, abuse or similar grounds" standard in its narrowest possible light, FERC has allowed pipelines to pass-through the costs of very high-priced gas although cheaper supplies were available. FERC's posture in this regard, through its signal to producers and pipelines that it would accept such behavior, gave producers added incentive to push gas prices to their limit and gave pipelines no incentive at all to resist. Even faced with an administrative law judge decision in the Columbia case calling for consumer rebates, FERC has failed so far to act on the public's behalf by upholding that decision.

FERC Actions to Raise Prices. Finally, gas prices are as high as they are today in large part because of anti-consumer actions taken by the Federal Energy Regulatory Commission. Since passage of the NGPA, FERC has aggressively used its authority to raise prices. Some of the more significant decisions made include:

> Area Rate Escalators. It has been estimated that FERC's ruling interpreting area rate escalator clauses has added more than $10 billion to the nation's gas bill. Area rate escalator clauses were designed to allow prices to increase if the FERC established that new price levels for particular categories of gas were justified by increases in the actual cost of production. Instead FERC ruled that area rate escalators would be triggered by the new NGPA ceilings which are arbitrary ceilings set by Congress without regard to cost.
>
> Tight Sands. In August 1980, the FERC allowed producers of gas from geological formations known as tight sands to charge a price equal to twice the price of section 103 new gas, without investigating whether the cost of producing the gas justified an incentive price and without examining the consumer impacts of the decision.
>
> Gathering and compression costs. Already this year, FERC has added $10 billion to the nation's gas costs over the next four years by allowing producers to charge pipelines for gathering and compression costs on top of NGPA ceiling prices. Before that decision, those costs had been included under the NGPA ceiling prices.

Deep water wells. FERC has ruled that producers of gas in offshore areas deeper than 300 feet can charge a price equal to twice the price allowed for Section 103 new gas. (Although the ruling was made on December 31, 1981, the price increases have not yet become effective. In addition to proposing increases for deep water wells, FERC also circulated a staff memo calling for substantial increases in the price of old gas, (section 104 gas). As a result of overwhelming Congressional opposition to that suggestion, FERC retreated, holding a notice of inquiry into the question and, to date, issuing no proposed rule.)

In sum, there are four major causes for today's high gas prices:

1) The inability of consumers and utilities to signal to producers that prices are too high, allowing producers to charge the highest allowable prices;

2) The market dominance of producers which has resulted in pipelines agreeing to unreasonable contract provisions;

3) The insulation of pipelines from the risks of high prices by purchased gas adjustments and rate designs which do not create incentives for least cost purchases; and

4) Anti-consumer actions by FERC.

II. The Administration Proposal

The Administration's proposal does nothing to solve any of the problems listed above. The consumer protection mechanism so highly touted by the President serve as only a flimsy veneer on the real purpose of the legislation: to decontrol old gas prices. The only barrier between decontrolled wellhead prices and the consumer is the Federal Energy Regulatory Commission, which has been given the authority under the President's proposal to determine just how high gas prices will go. Given its record and the numerous statements of its Chairman that gas prices should be raised, the so-called assurance of having FERC act on their behalf provides already beleagured gas consumers with small hope.

Furthermore, the plan creates many new opportunities for pipelines and producers to renegotiate price increases, but few to renegotiate price cuts. The Administration's plan exacerbates the underlying lack of competition in the gas industry by enhancing the producer's bargaining position at the expense of the pipeline and its customers.

I would now like to discuss in greater detail how the Administration proposal fails to solve the five problems listed above.

Prices. Today's prices are already too high. Price ceilings should be rolled back to provide real consumer relief. The President's bill removes price ceilings, including price ceilings on the nation's supply of lower cost old gas. We estimate that his proposal could increase residential prices by more than 60% over the next four years. First, the proposal would allow the immediate decontrol of any gas sold under a new or renegotiated contract. This would allow prices to rise above NGPA ceilings, which have already been shown to provide insufficient protection. Second, the Administration proposal would decontrol old gas, either under new or renegotiated contracts or, in any case, by January 1, 1985. Old gas, gas from wells drilled before 1977, is scheduled to remain permanently controlled under the NGPA. This decision alone would add $40 to $50 billion to the nation's gas bill. The gas cap which is supposed to act as a consumer protection will provide little relief since it is the average of decontrolled prices, which will be considerably above the prices old gas would receive under the NGPA. And the gas cap operates only until January 1, 1986, when there is no longer any limit on how high prices can rise.

Contract provisions. The Administration proposal does little to rectify current problems with take-or-pay provisions and virtually nothing to prevent indefinite escalator clauses from coming into play when gas is deregulated. Unlike most bills already introduced on the take-or-pay question, the Administration's bill does not statutorily limit the percentage of take-or-pays. Pipelines would simply have the discretion to lower take-or-pay obligations to 70%, a level that is considerably higher than the 50% figure most experts believe necessary to provide consumer relief. If a pipeline utilized that discretion, however, the producer is free to sell the portion of gas not taken to another purchaser at a decontrolled price, resulting both in the loss of supply to the pipeline and higher prices to the new purchaser. Finally, even this minimal protection expires on January 1, 1985, at which time take-or-pay obligations as high as 90% or 95% can come back into operation.

Similarly, limits on indefinite price escalators are marginal at best. Until January 1, 1986, indefinite price escalators for controlled gas would be prevented from operating to bring prices above the gas cap. However, such provisions in contracts where gas is deregulated could operate to drive prices above oil levels. Moreover, on January 1, 1986, indefinite price escalators in all contracts would be permitted to operate against the consumer interest.

Market Imbalance. The Administration bill does nothing to restore any semblance of balance to the gas market but instead gives the natural gas producer even greater power. Under the proposal, producers would have the right to abrogate contracts on January 1, 1985. Gas producers would then be free to shut in their gas wells, withdraw from service obligations, and shop around for purchasers who are willing to pay the highest price. There is no provision which would prevent producers from withholding gas supplies. Rather, the Administration proposal specifically eliminates existing law which requires the producer to continue to deliver gas to existing purchasers unless FERC grants the right of abandonment.

Finally, the Administration proposal fails to address the question of why pipelines entered into onerous contracts in the first place and why many have been unable to renegotiate more reasonable contracts in the past months. Indeed, the proposal makes it even more unlikely that pipelines will be able to force renegotiations to bring prices down and eliminate unfair contract provisions. Under the proposal, pipelines not producers would bear the risk for high-priced gas purchases, so producer stockholders and royalty owners could still insist that prices remain high in order to provide them with the highest possible profits.

Automatic Pass-throughs. The limitation on automatic pass-throughs is the centerpiece of the Administration's consumer protection mechanism. In reality, the pass-through provisions in the proposal actually limit FERC's authority to protect against unjustified costs being flowed through to gas users.

Under the proposal, no interstate pipeline purchase costs higher than the inflation rate could be automatically flowed through to consumers. FERC could pass-through additional costs after review, in a new form of hybrid rate cases that will add a new layer of bureaucracy at the Commission. Given the fact that FERC has granted pass-throughs in the past after review, (the latest case being the Panhandle East/Trunkline pass-through of

$400 million Algerian gas costs), it is very likely that it would allow them in the future. Moreover, any hope that this provision would actually protect users vanishes on several grounds. First, it is very probable that pipelines arguing they are paying prices at the federally approved gas cap level or replacing older gas with newer supplies, would be granted pass-through in the short term. Second, the Administration proposal appears to limit current FERC authority to deny pass-throughs below inflation if it is found that cheaper gas could have been purchased. In other words, instead of allowing current law to work to lower prices if pipeline purchases are unjustified, the Administration proposal guarantees that prices will continue to rise, at least by the inflation rate but most likely at a far faster pace given FERC's inclinations in the past. Third, the prohibition on automatic pass-through above the inflation rate ends on January 1, 1986, when all pass-throughs would be allowed without restriction. Pipelines could then pass-through costs previously denied. Fourth, pipelines would be able to seek higher rates in normal rate-setting hearings.

FERC implementation of the NGPA. The Administration proposal does not address the misuse the FERC has made of its discretionary authorities under the NGPA. FERC would continue to have discretion to raise old gas prices administratively and to add categories of gas to the high-cost section as it has done in the past.

The Administration claims that its legislation will reduce prices and, that if it does not, consumer protection provisions will prevent consumers from facing gas price increases greater than inflation. The Administration asks Congress and the public to trust that the Federal Energy Regulatory Commission, which has consistently acted to raise gas prices in the past, will suddenly seek to lower gas prices in the future. The proposal removes price ceilings that have limited increases while doing nothing to allow consumers to put downward pressure on prices as they could in other surplus markets. The Energy Coalition and the people we represent do not believe that the Administration proposal offers any hope of relief. Rather, we believe that it will help the major oil companies, which own nearly 75% of all old gas, at the expense of the nation's gas users, who will be left to pay the price of old gas decontrol.

III. Comprehensive Reform Legislation.

The Energy Coalition believes that comprehensive legislation is needed to address the major problems in today's natural gas market. We are supporting the principles in the Natural Gas Consumer Relief Act, which is being introduced by over 40 members of the House this week. That bill, unlike the Administration's proposal, will assure consumers of protection, since it would lower gas prices immediately and prevent rapid rises in the future. According to our analysis, the Natural Gas Consumer Relief Act would lower prices immedately, and limit future increases to less than the inflation rate. That would compare to an increase of 55% over the next four years under the current law and 67% under accelerated decontrol.

Any legislation adopted by the Senate should, we believe, include the following provisions in order to provide the comprehensive approach needed to solve current problems.

Prices. Gas prices must be lowered by rolling back bloated NGPA ceiling prices and then changing the rate of future escalation. Instead of guaranteeing future increases at a high rate, escalators should be sensative to changes in supply and demand. Thus, if energy prices were to fall in the future, gas ceilings should similarly decrease, allowing ceilings to reflect true market conditions. Price controls on new gas should be extended for two years, until January 1, 1987, in order to allow the presently chaotic market time to achieve a semblance of order. Old gas prices should remain under controls as in present law. High-cost gas should be capped at 150% of the new gas level unless a producer could justify, based on the cost of production, a higher price. Finally, Algerian gas should also be capped at 150% of the new gas level. Those provisions would provide Congress and the gas-using public with the certainty that gas price increases would be abated.

Contract Provisions. Unlike the President's bill, which allows take-or-pay provisions to continue operating and only limits indefinite price escalators for controlled gas until 1986, our approach is to limit take-or-pay percentages to 50% for three years and eliminate indefinite price escalators and most-favored nation clauses.

Balance in the market. In the Administration proposal, the current inability of utilities and consumers to become involved in decisions made by producers and pipelines is totally ignored. In fact, by removing FERC's discretionary authority to require that contracts be filed, it will become even more difficult to challenge pass-throughs based on contracts which are hidden. Contracts should be filed at the Commission and made available to the public to ease the ability to participate in FERC proceedings.

Perhaps more importantly, rate designs need to be established so that end use market signals become a primary consideration in pipeline purchasing practices. Producers and pipelines must no longer be allowed to act in isolation of consumer interests because of the regulatory mechanisms that ratify imprudent purchases and contracts with little or no regard for end users.

Automatic Pass-Through. While we continue to believe that the

Section 601(c) standard gives the Federal Energy Regulatory Commission adequate authority to require that pipelines make prudent purchases and seek for the least-cost mix, the Commission has failed to interpret its authority in that manner. Because of that, positive steps are needed to return to the standards contained in the Natural Gas Act which require pipeline purchases be just, reasonable and in the public interest. Unlike the President's proposal, that language would allow FERC to act to lower today's prices. And, again unlike the President's proposal, FERC's authority would be permanent.

FERC Implementation of the NGPA. Given FERC's past propensity to use the discretionary authority contained in the NGPA to increase prices, we believe that action must be taken to reign in FERC and prevent it from acting in an anti-consumer manner in the future. FERC's authority to raise old gas prices administratively and add new categories of "incentive-priced" gas to Section 107(c)(5) should be removed. Finally, FERC's latest decision to add production costs to existing price ceilings, raising consumer gas costs by $10 billion over the next four years, should be reversed.

IV. Conclusion.

The Energy Coalition believes that, unlike the Administration's bill, the Natural Gas Consumer Relief Act would give consumers assured protection against the ravages of high gas prices. It would also protect those small producers currently forced to shut in gas by limiting take-or-pay provisions which lock pipelines into higher-priced gas contracts. It would foster increased production by continuing the practice of targetting incentives to new and frontier exploration, insteading of allowing gas which has been produced for decades to receive the same price as gas which has yet to be discovered.

The choice before the Senate is clear. The approach the Energy Coalition supports guarantees lower prices while the Adminstration's bill would raise them. We ask for your support in crafting legislation that effectively solves the gas problem and provides true consumer relief.

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Washington Office

GAS PRICES OUT OF CONTROL:

The Cost of Inaction

1. Summary.

Rapidly rising gas prices are generating concern and creating hardship across the United States. The question of how natural gas should be priced has become the subject of a critical national debate. A wide range of proposals has been put forward to ameliorate this problem. This report analyzes the effect different natural gas pricing proposals would have on consumers and the national economy if they were adopted, and whether legislative action is necessary to protect gas users from price increases scheduled under the current law.

Three proposals are examined:

*Accelerating natural gas decontrol;

*Allowing phased decontrol to be completed through the current law (the Natural Gas Policy Act); and

*Stopping natural gas decontrol through enactment of comprehensive legislation to deal with the causes of natural gas price increases.

It must be stressed that this report is based on data and economic assumptions made by the Department of Energy and private forecasters. Department of Energy data are extremely conservative. This winter's heating bill increases have already exceeded DOE's original estimates. The consequences of decontrol -- either through Congressional inaction, or through accelerated decontrol -- are almost certain to be far more severe.

The conclusion of this analysis is that wellhead prices will rise 70% between 1982 and 1986 if decontrol is allowed to occur under the NGPA. That increase would be held to 27% if comprehensive legislation is enacted. Accelerated decontrol would result in a 94% increase.

Under the Natural Gas Policy Act, the nation's cumulative wellhead gas bill will be $135 billion higher over the next four years. Passage of comprehensive reform legislation to stop gas decontrol would save the nation $71 billion. If Congress accelerates decontrol, an additional $50 billion would be added to the nation's gas bill over the four years. Thus, accelerating decontrol would be $121 billion more expensive than stopping decontrol.

The typical household would save $640 over the next four years if Congress enacts comprehensive legislation to stop gas decontrol. Savings would be more substantial in most northern cities where consumption and gas costs are higher. Residential costs would increase by another $380 if Congress passes accelerated decontrol legislation. Thus, it would cost the typical northern gas heating household more than $1,000 if Congress chooses to speed up decontrol rather than stop it.

In the northern states, residential gas bills will increase by 55% between 1982 and 1986 under current law. If Congress stops decontrol, residential bills will increase by only 27%. Accelerated decontrol would increase bills by 67%. In other words, enactment of legislation to stop gas decontrol would freeze residential prices at their pre-winter levels (excluding inflation). Accelerated decontrol would boost bills by more than 30% excluding inflation.

Residential gas increases are only a fraction of the impact decontrol will have on consumers and on the economy. Natural gas is a key raw material in farming, the production of a host of industrial products and it heats thousands of office buildings and factories. Three quarters of the gas produced is used for those purposes, and when passed on show up as indirect costs to consumers. Assuming that these costs are passed on to consumers, Congress could save households $530 over the four year period by enacting legislation to stop gas decontrol.

Thus, for gas heating households, the cost of Congressional inaction would be $1,170 -- $640 in their gas bills and $530 in cost of living increases reflected in their purchases of goods and services. If Congress accelerates decontrol, gas heating households would pay $760 on top of the $1,340 -- $380 in their gas bills and $380 in indirect costs.

II. Background on Natural Gas Pricing.

A. Why Gas Prices are Rising.

1. The Natural Gas Policy Act

Ever since the Supreme Court affirmed the authority of the Federal government to regulate wellhead natural gas prices in 1954, producers have been seeking to obtain decontrol. In 1978, Congress passed the Natural Gas Policy Act, a bill which overturned the 25-year history of basing gas prices on the cost of production. This began a decontrol process designed to culminate in January 1985, when most gas would be deregulated.

Since Congress passed the Natural Gas Policy Act, wellhead prices (the price paid natural gas producers) have nearly tripled -- far outstripping the general rate of inflation over the same period of time. These wellhead price increases have caused enormous increases in home heating bills for natural gas customers. Residential natural gas bills have more than doubled since the NGPA was passed, rising by more than 25% in the last year alone. The nation's annual gas bill (at the wellhead) is now $30 billion more than it was in 1978.

Before 1978, natural gas prices were controlled at levels based on the demonstrated costs of production. The NGPA imposed a different regulatory structure, dividing gas production into three broad categories. Each major category was further divided into categories. A specific pricing structure was established for each category, determining ceiling prices, monthly escalation, and whether and when decontrol would occur.

The three broad categories are new gas (sections 102 and 103), old gas (sections 104, 105 and 106), and high cost gas (section 107). New gas is generally gas from wells drilled after February 1977. Almost all new gas is scheduled to be decontrolled on January 1, 1985. Old gas is generally gas from wells drilled before February 1977. Old gas sold in interstate commerce is not decontrolled; some intrastate old gas is decontrolled in 1985. High cost gas is gas that is assumed to have high costs or risks associated with its production. Gas from below 15,000 feet was immediately decontrolled, and several other types of gas have been given high "incentive" prices since then.

Although the Natural Gas Policy Act is extraordinarily complex, there are three fairly straightforward reasons the Act is causing residential bills in the north to soar: The displacement of old gas with new, the specific price ceiling and price escalator set by the NGPA for section 102 gas, and the high prices being paid for section 107 gas.

Since the NGPA was enacted, 2 Tcf (trillion cubic feet) of new interstate gas has displaced old gas. (Two Tcf is 20% of the domestically produced gas supplied to the interstate market.) Since new gas sells for more than twice the price of old gas, the displacement of new gas for old has more than doubled the cost of one fifth of the gas supplied to northern consumers. Although the decline in old gas consumption is inevitable, it is occuring more quickly than it should. Today, interstate pipelines are buying more new gas despite the fact that there are sizable quantities of old gas shut-in. (Gas is considered to be shut-in if it is available for delivery, but is not produced.) A major reason for those purchases is the contracts that pipelines have signed with gas producers. This problem is discussed below.

New gas prices are rising rapidly, despite the absence of evidence that its costs are increasing substantially and despite the general surplus. The reason new gas prices are rising so rapidly -- 100% since passage of the NGPA -- is that the ceiling for section 102 is automatically raised faster than the rate of inflation every month. Thus, section 102 prices have risen approximately 20% faster than inflation since enactment. Section 102 now accounts for 60% of all new interstate gas and will continue to increase rapidly.

The third provision of NGPA that is causing bills to rise rapidly is section 107. Section 107 represents only 6% of supplies in the interstate market, but because of its high price accounts for 20% of the total interstate gas bill. In 1978, the average price for section 107 gas was $7.24 -- triple the average price for all other types of gas. As with new gas the problem is twofold: section 107 high cost gas has replaced less expensive old gas which is otherwise available, and section 107 prices are simply too high, well above its production costs.

2. The Federal Energy Regulatory Commission.

Gas prices have risen far faster than many of the legislators who voted for the Natural Gas Policy Act anticipated in 1978. This is due to two important factors: actions taken by the Federal Energy Regulatory Commission to raise prices, and the terms accepted by major interstate pipelines in their contracts with producers. Those factors are considered in turn.

Since passage of the NGPA, the FERC has sought to aggressively use its authority to raise prices. The first major ruling by the FERC on area rate escalator clauses substantially raised the price of gas. It has been estimated that this decision alone has added more than $10 billion to the nation's gas bill. Area rate escalator clauses were designed to allow prices to increase if the FERC established that new price levels for particular categories of gas were justified by increases in the actual cost of production. Initially FERC ruled that area rate escalators should not be triggered by the new NGPA ceilings, which were arbitrary ceilings set by Congress without cost justification. Later, FERC reversed its position under pressure from producers and over the protests of state utility commissions, utilities and members of Congress.

In August 1980, the FERC allowed producers of gas from geological formations known as tight sands to charge a price equal to twice the price of section 103 gas, without investigating whether the cost of producing the gas justified an incentive price and without examining the consumer impacts of the decision.

In other decisions, the FERC added to gas prices by changing the definition of a Btu of gas, by allowing pipelines to collect NGPA rates for pipeline-produced gas, and by expanding the definition of stripper well gas.

The current chairman of FERC, C.M. Butler has repeatedly voiced his support for total deregulation of natural gas, and has initiated a number of actions that have caused gas prices to rise. During his term, FERC has:

--failed to deny pass-throughs when pipelines purchased high-cost gas although cheaper supplies were available. This was accomplished by interpreting the language in Section 601(c)(2), of the Natural Gas Policy Act which allows the FERC to deny pass-through of gas costs based on "fraud, abuse or similar grounds," in its narrowest sense; that is, only in instances when a producer has been misleading in classifying its gas. Through this decision FERC has avoided its responsibility to hold pipelines accountable for minimizing the costs of their gas purchases.

--allowed producers to add on the costs of gathering and compressing gas to ceiling prices, a move which will cost consumers $3 billion a year over the next two years.

--ruled that producers of gas in offshore areas deeper than 300 feet can charge a price equal to twice the price allowed for Section 103 gas (a category of new gas). Although the ruling was made on December 31, 1981, the price increases have not yet become effective.

3. The Contracts Problem.

Today, consumers are forced to endure skyrocketing gas price increases at the same time that the nation is experiencing a gas surplus. Expensive gas is being bought while inexpensive gas remains shut-in because pipelines have locked themselves into contracts with the major gas producers that obligate them to buy high priced gas regardless of the prevailing market conditions. This is referred to as the contract problem. It is rooted in the lack of competition that exists in the natural gas industry.

Regulation of natural gas prices originally grew out of the lack of competition in the natural gas industry. Natural gas producers -- the major oil companies -- have enormous leverage over pipelines. Pipelines, protected by automatic pass-throughs, have little reason to counter the power of producers. Indeed, pipelines often purchase gas from their own subsidiaries or affiliates. Utilities, in turn, are constrained from shopping around for their purchases. Finally, the ultimate consumers -- households, farms, businesses, hospitals and schools -- have only one source from which to purchase gas.

Pipelines have been signed contracts with producers that have had the effect of substantially increasing gas costs despite the NGPA ceilings. Many pre-NGPA contracts were rewritten to include provisions that increase costs above what was anticipated. The most important contract provision is the "take-or-pay" clause. This provision requires a pipeline to purchase a minimum quantity of gas, regardless of whether the pipeline has a market for the gas. Since these take-or-pay provisions are in virtually every contract for high-cost and new gas, and have durations of 10-15 years, the result has been that pipelines have committed themselves to buying enormous quantities of expensive gas instead of lower-cost gas that is available to them. The American Gas Association estimates that 2.7 tcf of lower-cost natural gas is currently being shut in -- gas that could displace the high-cost gas the pipelines have committed themselves to buying.

For consumers, the lack of competition in the natural gas industry, most dramatically manifested in the prevalence of high take-or-pay requirements, has meant rapidly rising prices in a time of surplus.

Another type of contract provision which has generated concern is the indefinite price escalator clause. That clause, which generally comes into effect if deregulation occurs, can take several forms. The most egregious are the most-favored nation clauses, which tie prices to the highest price paid by another buyer in the same geographic location, and oil parity clauses, which tie gas prices to a percentage of oil prices. Since many oil parity clauses put that percentage above the oil price, (say 110% or 120%), they would act in combination with most-favored nation clauses to drive gas prices substantially higher than the market-clearing price.

B. The Political Debate

1. The Natural Gas Debate in the 97th Congress.

Both as a candidate and as a President, Ronald Reagan has continually affirmed his commitment to natural gas decontrol. In the beginning of the 97th Congress the Administration announced its intention to seek immediate and total natural gas decontrol. Subsequently, the Administration and the oil industry revised their legislative agenda, calling instead for accelerated decontrol, including the eventual decontrol of old gas. Those efforts to obtain legislation were frustrated in Congress, and no action was taken.

With action in Congress stalled, the oil industry and the administration sought to accomplish many of their goals through actions by FERC -- backdoor or administrative decontrol. FERC began a number of proceedings to pave the way for additional price increases. A rule was proposed to provide incentive prices for natural gas produced from wells drilled to between 10,000 feet and 15,000 feet-- intermediate deep wells. The Citizen/Labor Energy Coalition estimated it would cost consumers several billion dollars. More significantly, FERC officials floated a proposal to dramatically raise the price of old gas through the regulatory process. Internal FERC staff memos stated that the Commission could bring old gas prices to "market clearing" levels without Congressional action. Congressional protest forced FERC to revise its plans, and, to date, the issue remains undecided.

2. The Current Natural Gas Debate.

Natural gas producers and the Reagan Administration remain committed to seeking legislation to decontrol gas in this Congress. Natural gas pipelines are split over which legislative approach should be taken -- some supporting the producers in their call for decontrol, some calling for revision of some contract provisions, and others supporting continuation of the decontrol process established by the Natural Gas Policy Act. Although there is no one utility position at this time, most utilities in the northeast and the midwest are actively seeking legislation that addresses the contracts problem. Many, concerned that prices are higher than their ratepayers can afford, support legislation that would lower current prices, extend controls beyond 1985 and create more leverage on pipelines to buy the least expensive gas available.

Consumer organizations, and many utilities, feel that the only hope for genuine price relief for consumers lies in passage of comprehensive legislation that deals with all the problems in the natural gas market. The key elements of this legislation are:

*Stopping Natural Gas Decontrol. Given the non-competitive nature of the natural gas market and the contracts problem, the decontrol called for by the NGPA should be delayed for at least two years, and until litigation resulting from legislation affecting contracts is resolved.

*Reducing the maximum allowable take-or-pay levels. Contracts should not be allowed that require the pipeline to purchase more than 50% of the contracted amount. Pipelines should be allowed to reduce their take of gas if market conditions change and they are unable to sell their gas to their customers because the price is too high. Additionally, indefinite price escalators, such as most favored nation clauses, should be outlawed.

*Requiring pipelines to minimize their gas costs. Today's gas market is dramatic evidence that pipelines are not seeking the least cost mix of natural gas purchases from producers. Pipelines have little incentive to do so since FERC allows them to pass their increased gas costs on to utilities automatically. Comprehensive legislation should force FERC to hold pipelines accountable by denying automatic price increases to pipelines that cannot demonstrate that they have minimized their gas costs.

*Reforming NGPA price ceilings and escalators. In most cases, the prices provided by the NGPA are too generous. Ceiling prices should be rolled back to levels that prevailed before this winter. Future increases should generally be kept at or below the rate of inflation. Gas price ceilings should decline if the price of competing fuels decline. Uncontrolled deep gas should be capped at 150% of the section 103 price. Producers seeking higher prices should be required to prove to FERC that the higher price is justified on the basis of costs. Other ceiling prices [illegible] their average 1982 levels.

*Reversing actions taken by FERC to raise prices. Additionally, FERC's authority to raise old gas prices should be revoked.

*Reducing expensive foreign imports. The State Department should renegotiate with Canada and Mexico for lower prices. Natural gas imports from other countries purchased under privately-negotiated contracts should be held to the same standards relating to purchases of other expensive gas.

III. The Impact of Natural Gas Decontrol.

A. Methodology.

This study projects the impacts that would result from three of the most discussed approaches to the natural gas problem. The report examines the impact in each of the next four years (1983 -- 1986). These approaches are:

*Accelerated natural gas decontrol -- Gas drilled after January 1983 would be decontrolled immediately, and all gas would be decontrolled by January 1985.

*The Natural Gas Policy Act -- Congress takes no action, and decontrol would occur as scheduled on January 1, 1985.

*Comprehensive legislation to stop natural gas decontrol -- Congress enacts legislation that incorporates the major provisions described in the previous section.1.

Each of the three scenarios is defined in detail in the appendix. The appendix also outlines the assumptions used in analysing the scenarios. Most are based on projections made by the Energy Information Administration.

B. National Impact.

Enactment of comprehensive legislation to stop gas decontrol would save the nation $71 billion over the next four years. Accelerating decontrol would add another $50 billion over the four years. Table I presents those results.

Added Costs of Decontrol Scenarios Compared to Legislation to Stop Decontrol

Natural Gas Policy Act	$ 71 Billion
Accelerated Decontrol	$121 Billion

If accelerated natural gas decontrol occurs, wellhead natural gas prices will rise by 94% between 1982 and 1986. This compares with wellhead price increases over the same period of 70% if decontrol is allowed to occur under the NGPA. Wellhead prices would increase by only 27% if comprehensive legislation is adopted.

Table II

Average Pipeline Acquisition Prices, 1983 - 1986
Dollars per Thousand Cubic Feet

	1983	1984	1985	1986	Percent Increase '82-'86
No Decontrol	$2.44	$2.65	$2.89	$3.13	27%
Natural Gas Policy Act	2.89	3.18	4.56	4.22	70
Accelerated Decontrol	3.37	4.83	4.58	4.82	94

C. Residential Impacts

Enactment of comprehensive legislation would save the typical gas heating household $640 on its utility bills over the next four years. Table III presents the savings that would result from enactment of comprehensive legislation to stop gas decontrol. Accelerated decontrol would add $380 to a household's bills over the four years. The savings from passage of comprehensive legislation would be greater in most northern cities.

Table III

Added Costs of Decontrol Scenarios Compared to Legislation to Stop Decontrol

	Cost
Natural Gas Policy Act	$ 640
Accelerated Decontrol	1,020

The same gas utility customers would see its utility bills increase by 55% over the four year period if decontrol is allowed to occur through the NGPA. Accelerated decontrol would boost residential gas bills by 67%.

Comprehensive legislation to stop natural gas decontrol would limit utility bill increases to 27% over the same four year period -- a freeze in real (inflation-adjusted) prices. In the first year, prices would actually stabilize or be slightly rolled back in most cities.

The indirect costs of decontrol would be enormous. Average households would pay $530 more over the four years for food and other goods and services than they would pay if Congress enacts comprehensive legislation to stop gas decontrol. Accelerated decontrol would add another $380 to these indirect costs for a total of $910.

Table IV

The Added Costs of Gas Decontrol for the Typical Household

	Direct	Indirect	Total
Natural Gas Policy Act	$ 640	$530	$1,170
Accelerated Decontrol	1,020	910	1,930

D. Regional.

Although natural gas decontrol would devastate every region of the country, the Midwest would be hardest hit. 70% of the households in these states use gas to heat their homes. Harsh winters require substantial gas consumption. Accelerated gas decontrol would increase the Midwest's gas bill by $32 billion over the four year period as compared to comprehensive legislation. Comprehensive legislation would save $21 billion over decontrol through the NGPA.

The Midwest is further disadvantaged by gas price increases owing to the dependence of most of the region's heavy industry on the fuel. Thus, decontrol will exacerbate the region's unemployment and dollar drain problems.

Table V

Added Costs of Decontrol Compared to Legislation to Stop Decontrol, 1983-1986, Billions of Dollars

	NGPA	Decontrol
Middle Atlantic	$7.3	$11.3
East North Central	13.6	21.0
West North Central	7.5	11.6
New England	1.3	1.9
East South Central	3.2	5.0
South Atlantic	5.5	8.5
Pacific	8.1	12.5
Mountain	3.1	4.8
West South Central	21.4	44.6
	$71.0	$121.2

*See note 3 for members of regions

E. Industrial Impacts.

Decontrol -- whether the result of the NGPA or accelerated decontrol -- will have disastrous effects on all gas consumers, not just residential customers. Accelerated decontrol would add $40 billion to industries' gas bills over the next four years above what they would pay if comprehensive legislation is enacted. Industry would pay $28 billion more if decontrol occurs through the NGPA than they would if comprehensive legislation is enacted. In addition, decontrol through either scenario would add billions of dollars to the nation's food bill, create more unemployment and bring many small businesses to bankruptcy.

Table [illegible]

Added Costs of Decontrol to the Industrial Sector, as Compared to Legislation to Stop Decontrol, 1983 -- 1986, Billions of Dollars

	NGPA	Decontrol
Middle Atlantic	$2.0	$3.4
East North Central	5.2	8.9
West North Central	2.0	3.4
New England	.2	.4
East South Central	2.0	3.4
South Atlantic	2.4	4.1
Pacific	2.4	4.0
Mountain	1.2	2.0
West South Central	11.2	19.0
	28.6	48.8

F. Local Impacts.

Gas heating households in cities across the country will be affected differently by each of the proposals. The variation is large owing to the fact that the mix of gas purchased by the pipelines that serve the utilities in the cities varies greatly. The following table lists ten major cities that will save the most over the next four years if Congress passes legislation to stop gas decontrol. A more complete list is included in Appendix B.

Table VII

Typical Gas Heating Household Savings from Legislation to Stop Gas Decontrol, 1983 -- 1986

	NGPA	Decontrol
1. Hartford, CT	$1,306	$1,989
2. New York City, NY	1,151	1,553
3. Providence, RI	1,037	1,690
4. Springfield, MA	1,017	1,552
5. Buffalo, NY	979	1,475
6. Chicago, IL	945	1,587
7. Columbus, OH	944	1,223
8. Pittsburgh, PA*	943	1,246
9. Baltimore, MD	901	1,160
10. Cincinnati, OH	896	1,183

*Pittsburgh is served by three utilities. This figure applies to Columbia customers.

Notes

1.It is important to note that reversal of FERC's area rate escalator clause decision is NOT included in the residential impacts or the estimates of average wellhead prices. Government estimates are that this decision is costing consumers several billion dollars each year. However, there exists no available data source that would allow estimates of the effect on particular consumers or categories of natural gas to be made.

2.The Energy Information Administration of the Department of Energy has projected the quantities of natural gas expected to be produced in each of the next four years in each of the categories established by the NGPA. The pricing schemes in each of the scenarios, as well as the likely effect on the quantity of gas supplied in each category, were applied to this projection of supply. Price estimates are based on projections by the Administration and major macroeconomic forecasters.

3. Definition of Regions.

MIDDLE ATLANTIC	NY, NJ, PA
EAST NORTH CENTRAL	IL, IN, MI, OH, WI
WEST NORTH CENTRAL	IA, KS, MN, MO, NB, ND, SD
NEW ENGLAND	CT, MA, VT, NH, RI, ME
EAST SOUTH CENTRAL	AL, KY, MS, TN
SOUTH ATLANTIC	DE, DC, FL, GA, MD, NC, SC, VA, WV,
PACIFIC	AK, CA, HI, OR, WA
MOUNTAIN	AZ, CO, ID, MT, NV, NM, VT, WY
WEST SOUTH CENTRAL	AR, TX, LA, OK

Appendix -- Methodology

Estimating the impact of the various scenarios is a complex task, made more difficult by the inherent uncertainty in energy markets, and the limits of publicly available data. Within these constraints, the estimates generated are conservative, relying on data and economic assumptions used by those who advocate decontrol, and who have traditionally underestimated the potential for steep energy price increases. For these reasons, it seems likely that these estimates understate the consequences of decontrol.

A. Specification of the Scenarios

1. Accelerated Decontrol.

Many proposals have been put forward to accelerate natural gas decontrol. The following scenario is based on points that are common to most of the decontrol approaches.

*Immediate decontrol of gas drilled after 1/1/83.

*Decontrol of all other categories of gas except old gas (104, 105 and 106) on 1/1/84.

*Decontrol of old gas on 1/1/85. Old gas prices are phased up to meet anticipated market clearing levels in the intervening years.

2. Natural Gas Policy Act.

*No new FERC backdoor decontrol policies are adopted.

*The NGPA remains unchanged.

3. Comprehensive Legislation to Stop Gas Decontrol.

*Prices for sections 102, 103, 104, 106, 108 and 109 are rolled back to August 1982 levels. Ceiling prices for these categories increase at the rate of inflation for the following three years. Ceilings on sections 102, 103 and 105 gas are extended at least until 12/31/86.

*Section 107 prices are capped at 150% of section 103 prices.

*Reform of contract provisions combined with FERC requirements to minimize gas costs will force pipelines to replace their high cost, imported and section 102 gas with less expensive gas.

*Prior FERC decisions (for example gathering and compression costs),

B. Derivation of Prices and Quantities.

1. Quantities.

A model was created to estimate the quantity of gas in each NGPA category, for each scenario, for each year. The basis for these projections is the Energy Information Administration's estimates. These quantities were adjusted where specific aspects of the proposals would change the volume produced in a particular category.

It is assumed that the comprehensive legislation causes 1 tcf of expensive gas (section 107, imports and section 102) to be replaced by less expensive, shut-in gas in the interstate market. This is a conservative estimate. Government and industry estimates of the amount of currently shut-in gas range from 1 tcf to 3 tcf.

It is assumed that under the comprehensive legislation the combination of reform of take-or-pay provisions and the requirement that utilities minimize gas costs causes utilities to reduce their take of section 107 gas to the 50% level.

2. Prices

The price for decontrolled gas was estimated in the following way. (a)A crude oil equivalent price was established based on the Department of Energy and major macroeconomic forecasters' estimates of crude prices in a given year. (b)seventy percent of that figure was taken as the price to which decontrolled gas would rise. (c)In the first year in which decontrol occurs (1984 for the accelerated decontrol scenario and 1985 for the NGPA scenario) it is assumed that indefinite price escalators cause prices to rise to a level above the decontrol price, to levels in EIA's base case. In the second year, it is assumed that the market adjusts, and the price of gas with indefinite price escalators is reduced to the decontrolled level.

Estimates of future crude oil prices are particularly precarious, and are currently the subject of great controversy. For this reason, the fairly conservative assumption was made that crude oil prices would remain constant over the four year period. Many private economists still believe that in the coming years, the price of crude oil will firm up.

Section 107 prices are assumed to decline steadily over the next four years.

C. Data Sources.

As already indicated, virtually all of the data used in this analysis is from the Department of Energy. The following presents the data sources for the most important parts of the model.

*Quantities of gas in each NGPA category are based on the Energy Information Administration's "The Current State of the Natural Gas Market Part I (December 1981)."

*Quantities of gas in each NGPA category by major interstate pipeline are based on the Energy Information Administration's survey in the "Current State of the Gas Market Part III (September 1982)."

*Quantities and prices affected by indefinite price escalator clauses are based on estimates made in the Energy Information Administration's "Current State of the Gas Market Part II(June 1982)."

D. Economic Assumptions.

Cost impacts are presented in current dollars. A survey of estimates made by the government and by private forecasters was made to select inflation estimates. These estimates are: 5.8% in 1983, 6% in 1984, 6.5% in 1985 and 6.4% in 1986.

E. Derivation of City Impacts.

The model used to derive national impacts for eac scenario was used to do the same for each of twenty five major interstate pipelines. The resulting average rolled in price of gas for each pipeline was used to generate weighted averages for the purchases from pipelines by major utilities in most of the major consuming states. The mix of gas purchased by pipelines is based on the EIA data cited above. The mix of purchases by the utilities from the pipelines is based on information from several sources including "Moody's Public Utility Manual," and contacts with individual utilities and pipelines. Average consumption per household in each city is based on information published by the American Gas Association in their "Househeating Survey," and on "Brown's Directory of Gas Distribution Companies.

Appendix I -- Estimated Savings for Typical Gas Heating
Household as Compared to Decontrol Through
the Natural Gas Policy Act and Accelerated
Decontrol
1985 - 1986

	NGPA	Decontrol
Hartford, CT	$1,306	$1,989
Brooklyn, NY	1,245	1,623
New York City, NY	1,151	1,553
Flint, MI	1,114	1,527
Worchester, MA	1,049	1,654
Jackson, MI	1,038	1,451
Providence, RI	1,037	1,690
Springfield, MA	1,017	1,522
Buffalo, NY	979	1,435
Chicago, IL	945	1,587
Columbus, OH	944	1,223
Pittsburgh--Columbia	943	1,246
Battle Creek, MI	928	1,670
Toledo, OH	913	1,190
Baltimore, MD	901	1,160
Cincinnati, OH	896	1,183
Erie, PA	889	1,351
Boston, MA	837	1,333
Prince George, MD	872	1,121
Warren/Youngstown OH	860	1,238
Denver, CO	858	1,220
Allentown, PA	851	1,091
Harrisburg, PA	851	1,091
Washington, D. C.	846	1,105
Pittsburgh--Peoples	839	1,224
Wilkes-Barre,PA	831	1,078
Cleveland, OH	826	1,204
Rockford, IL	802	1,344
Lexington, KY	786	1,028
Des Moines, IA	781	1,339
Rochester, NY	758	1,088
Decatur, IL	742	1,298
Louisville, KY	731	1,197
Wheeling/Charleston, WVA	714	1,196
Springfield, IL	699	1,318
Peoria, IL	692	1,302
Kansas City, MO	692	1,131
Moline, IL	690	1,161
Cedar Falls, IA	681	1,145
Waterloo, IA	674	1,156
St. Louis, MO	667	940
Topeka, KS	646	1,056
Cedar Rapids/Davenport, IA	624	1,068
Omaha, NB	589	1,038
Lincoln,NB	575	976
Atlanta, GA	559	831
Los Angeles, CA	434	669
San Francisco, CA	290	394
Seattle, WA	266	433
Portland, OR	257	422

The **Chairman**. Thank you very much.
Dr. Cooper.

STATEMENT OF DR. MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER ENERGY COUNCIL OF AMERICA

Dr. **Cooper**. I appreciate the opportunity to appear before the committee today, and I will summarize my testimony.

In a sense, I am simply picking up where I left off 16 months ago when I last testified before the committee on the malfunctioning of the natural gas market.

At that time, I warned that there were fundamental flaws in the industry that were obscured by the fancy name we have put on basic problems—push, and fly-up, and so forth.

I emphasize that it was absolutely critical to recognize that the problems in the natural gas market do not stem from the Natural Gas Policy Act.

They stem from the imperfections in the gas industry and the unwillingness of the Federal Energy Regulatory Commission to counteract those imperfections.

Those conclusions are even more true today.

In the past 16 months FERC has done more of the same, continuing its course increasing rulemaking, opening a campaign to increase the price of old gas and refusing to use its powers to quell abusive contracting and bidding practices.

The evidence that has accumulated with respect to the behavior of the natural gas market shows its complete maldistribution of market power, and that consumers cannot receive adequate protection by simply letting the market do its work.

If one considers the imperfections in the market, oligopoly power at the wellhead, joint ventures, affiliations, and automatic pass-throughs between wellhead and citygate, and captive consumers at the burner tip; the evidence is not surprising at all.

It is not surprising to find that 30 percent of all contracts on pre-1973 gas had been renegotiated within a few years of the passage of NGPA.

It is not surprising to find that for all intents and purposes the industry has indexed its price to that of No. 2 fuel oil, not the market in which gas distributors compete, but the market in which major integrated oil companies maximum their profit.

It is not surprising that when a few pipelines have tried to claim force majeure as their markets collapse, producers have sued, saying, in essence, that they are immune to market forces and will extract whatever they can from the highest price market available.

Indeed, the almost lightening speed with which these contract provisions work their way into every nook and cranny of the industry, and the snail pace at which a very few of them have been modified testifies to the maldistribution in the chips in the bargaining process.

An even more compelling piece of evidence lies in the response of natural gas prices, the deepest recession since the Great Depression.

The demand for natural gas and oil have plummeted. In response to recession-induced declines and demands crude oil prices have fallen about 10 percent.

About 1.5 trillion cubic feet of industrial demand for natural gas has been lost and a 3 trillion cubic foot surplus has developed in the market.

The free negotiations between producers and pipelines change the contract terms which were propping up prices. Do those immense downward pressures have any effect on price? Not at all.

With oil prices falling, and inflation running at 4 percent, natural gas prices have defied the laws of the market and increased by over 20 percent.

The flaws that I see in the natural gas market operate at different levels of intensity in different regions of the country, and at different moments in time; but taken together they constitute a fundamentally flawed structure. The fact that FERC has failed to stop transactions at very high prices is interesting and important that testifies to FERC's behavior; but the fact that those transactions occur in the first place is paramount, and it is the direct result of the institutional and structural imperfections in the gasline.

Whereas, 16 months ago, I concluded that title I of NGPA could be implemented by a vigorous and conscientious regulatory commission to achieve its stated goal, I am now convinced that FERC has done a fundamental injustice to the congressional intent of the act and that the imperfections in the industry are extremely deeply rooted, so deeply rooted that NGPA must be retooled.

The balance that NGPA tried to achieve between consumer protection and supply-side stimulation can still be achieved, and I offer the following suggestions with their attendant reasons.

First, old gas must not be decontrolled. This would capture about half of the economic rents that are likely to be available on natural gas production to the end of this decade.

Second, indefinite price escalators which use other forms of energy as a referrent and most-favored-nation clauses which referred to other gas prices must be abolished permanently.

This cross-referencing of prices violates the very essence of competition at the wellhead and the burner tip. "Take-or-pay" clauses must be set at levels necessary to do what they are intended to do, provide stable finance to the industry. They must not be allowed to be used to bid for gas or insure producers high and unjustified profits.

All automatic passthroughs must be permanently eliminated to remove the insulation of pipelines from the consequences of their bidding practices.

The discretionary powers that FERC has used to push up the prices of gas must be abolished, and the damage that it has done must be corrected.

Unless this is done, the perverse incentives that FERC has created will continue to distort the supply response while it is drafting economic rents from consumers.

The definition of fraud and abuse that FERC has been allowed to apply under the Natural Gas Policy Act has proven totally inadequate to protect consumers or discipline the market.

Therefore, we must return to the just and reasonable standards of the Natural Gas Act.

Finally, the rapid price increase over the last few years, which has in fact worked through the formula that Congress created, must be altered.

Prices must be rolled back and smaller annual increases must be allowed.

It is of paramount importance to stress the fact that the administration package is not consumer protection; nor can it lead to a solution to the problem by simply giving a blank check to the very same parties who created the problem in the first place and who have been unable to solve it in more than 2 years under immense pressures to lower price.

But, more importantly, I would stress the fact that the administration solution is not an economically efficient solution. The transfer of economic rents to and the extraction of noncompetitive profits by the natural gas producers, especially the major who own the majority of old gas, will simply drain resources away from other sectors of the economy that are in desperate need of capital and consumer spending.

To allow the politically manipulated price of oil to set the price of natural gas, which is in essence what the administration's proposal will do, is to give up all hope of allocating our economic and energy resources in a manner that is consistent with the economic forces, values, and needs of our domestic economy.

Only through the measures we propose can we insure that the price of gas will be driven by the competitively determined cost of production and thereby achieve both consumer protection and national economic efficiency.

I appreciate the opportunity to testify, and I will be glad to work with the committee as it seeks an equitable and efficient solution to the problems in the natural gas industry.

The CHAIRMAN. Thank you very much.

[The prepared statement of Dr. Cooper follows:]

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Testimony of

Dr. Mark Cooper
Director of Research
Consumer Energy Council of America

Before the
Committee on Energy and Natural Resources
United States Senate

on the
Natural Gas Hearings

March 10, 1983

Mr. Chairman and Members of the Committee:

My name is Dr. Mark Cooper and I am Director of Research of the Consumer Energy Council of America (CECA). CECA is a broad based coalition of major national consumer, labor, farm, public power, rural electric cooperative, senior citizen, urban, low income, and minority organizations (see attached list).

I appreciate the opportunity to testify before the Committee today on the current proposals to address the problems in the natural gas market.

BASIC ISSUES

In simple terms, there are two basic questions facing this Committee and the Congress: 1) What should be done with the economic rents of natural gas production? 2) Is there a significant potential for non-competitive profits in the industry, which, in the current context, focuses a great deal of attention on the causes of the aberrant contract provisions that we find throughout the natural gas industry?

Sixteen months ago, when I last appeared before this Committee to testify on the natural gas industry, the questions were, on the surface, very different.

At that time we were debating whether there was a cushion problem. Time has shown that there was not and is not a serious problem.

We were debating whether there was a contract problem.

Time has shown that there was and is a very serious problem.

We were debating whether and how large the fly-up upon decontrol would be. Time has shown that the potential is there for a fly-up, but its magnitude is uncertain since, given the current price structure of the natural gas industry, it will be determined by the OPEC members and the multinational oil companies who are negotiating oil prices at various places around the world this spring.

Yet, I warned at that time that there were fundamental flaws in the industry that were obscured by these fancy names for basic problems. I emphasized that it was absolutely critical to recognize that the problems in the natural gas market do not stem from the Natural Gas Policy Act. They stem from the imperfections in the natural gas industry and the unwillingness of the Federal Energy Regulatory Commission to counteract those imperfections. That conclusion is even more true today.

In my testimony I addressed both of the questions raised above and I will do so again today.

ECONOMIC RENTS

With respect to economic rents, I pointed out that NGPA was intended to protect consumers by capturing economic rents in the form of lower prices, but that the industry and the Federal Energy Regulatory Commission were robbing consumers of that protection by the well classification process as well as by rulemakings on ceiling prices and cost recovery. These raised the effective ceilings and shifted production into higher priced categories. Let me restate and update that long history of flaunting the Congressional intent of the Act, since one of my basic conclusions is that this kind of discretionary power to raise prices must be stripped from the Commission.

FERC's Well Classification Procedures Allow Too Many Wells in the High Price Category

Two decisions typify FERC's continuous interpretation of the law so as to make it extremely easy to have gas classified into high priced categories: the tight sands decision (Order No. 99) and the stripper well decision (General Rule).

In the tight sands decision, rather than establish a clear and precise definition of tight sands, FERC chose a loose definition which required a case-by-case consideration of well classifications. Thus, in determining how to classify wells, each individual formation becomes a special, separate and ambiguous case, which requires a separate FERC regulatory action. This creates a tremendous regulatory burden on FERC and makes it extremely difficult for consumers to monitor the classification process.

In the decision to take a flexible approach to tight sands gas (Section 107 gas), FERC bent NGPA to its will. In the decision on stripper wells (Section 108 gas), FERC bent NGPA so far that it all but broke.

Title I defines stripper wells clearly and precisely to exclude wells producing more than an average of 60 MCF per day over any 90-day period and/or gas associated with the production of any crude oil.

However, in "interpreting" the statute, FERC broadened the definition of stripper wells to include the production of limited quantities of crude oil, which the law expressly prohibits. Further, FERC broadened the definition to include wells which average 60 MCF per day over a 12-month period rather than the 90-day period explicitly stipulated by the statute.

As of mid-1982, Section 107 gas represented about 7 percent of production for the interstate market, but accounted for almost 20 percent of the total cost of gas. It has accounted for almost two-thirds of the increase in the cost of gas between mid-1981 and mid-1982.

FERC has mismanaged Sections 107 and 108 gas, above all by diverting the price incentives to find and produce new gas into these, the least productive categories. Consequently, the incentive to look for and produce conventional new gas with high production potential has certainly been reduced. Some portion -- no one knows how much -- of the gas classified in Sections 107 and 108 could have and would have been produced at half the price under Sections 102 and 103 if FERC had not unreasonably broadened the definitions of the high cost gas categories.

FERC Has Allowed Unreasonable Price Increases Within Categories

Title I of NGPA sets maximum lawful prices under each category subject to regulation, and Title VI preserves FERC's powers to examine all prices, be they regulated or deregulated. This is the second area in which FERC has neglected the consumer protection aspect of the Congressional compromise embodied in NGPA. FERC has allowed unreasonably high prices both through explicit decisions and by failing to use its authority.

In the case of tight sands, FERC reviewed the evidence and found that the elasticity of supply (i.e., the percentage change in production that results from a one percent change in price) begins to decline dramatically at somewhere between $3.50 and $5.00 per MCF (Order No. 99). When prices reach a threshold somewhere between $3.50 and $5.00, the evidence suggested that either additional price increases failed to result in greater supplies or that the additions to supply were small.

In determining a price for gas in the tight sands decision, FERC, claiming to be reasonable, rejected the high and low ends of the price range. Unfortunately, instead of splitting the difference and selecting the midpoint between $3.50 and $5.00, FERC settled on a price of $4.54 per MCF, which, in fact, gave the producers 86 percent of the difference. Furthermore, we should recall that FERC's definition of tight sands is very loose, so that the low end of the price range would have been more appropriate. There was clearly no effort on FERC's part to maintain price protection for consumers.

In the case of the deep gas category, FERC has failed to exercise its powers under Section 601 of Title VI to curb "fraud and abuse" by producers. FERC has permitted high cost transactions to occur at price levels ($8 or $9 per MCF) far beyond anything the market should reasonably bear. The State of California and a number of other parties have argued in pleadings before FERC that the Commission has the power and the obligation to correct these structural problems in the market. FERC has failed to intervene in the market to use its power or carry out its obligation. Only recently has an administrative law judge finally decided that the abuse has become so blatant that it can no longer be ignored. However, it remains to be seen what the Commissioners will do.

FERC Has Allowed Rapid Increases in "Old" Gas Prices

The final element in the high price puzzle that FERC has created is the run-up in old gas prices. A key FERC decision (Order No. 23) involved area rate clauses in contracts between pipelines and producers. These clauses allow contract prices to change automatically in response to changes in regulated price. After first ruling that NGPA should not trigger such clauses, FERC reversed itself in Order No. 23:

> After evaluating the comments and views expressed, it would appear that, while the Congress cannot be said to have conclusively intended to have area rate clauses trigger to the Natural

> Gas Policy Act ceiling prices to the preclusion of the parties' ability to negotiate lesser prices, the Commission cannot find a convincing basis upon which to conclude that the Congress did not intend to allow area rate clauses to trigger to the statutory ceiling prices.

Billions were at stake in increased bills for consumers with little or no prospect of additional supply, but FERC, once again, exercised all its flexibility in favor of producers and to the detriment of consumers.

Recent FERC Actions: More of the Same

In the sixteen months since I testified, the industry and FERC have only made matters worse. FERC continues with its "near deep", "deep water" and "liquid and liquifiables" rulemakings, all of which will raise prices. Having stretched its powers to the limits, FERC has opened its campaign on old gas. Yet, it has refused to exercise its powers to regulate pipelines. After a few pre-election crumbs thrown to consumers, it issued its "gathering cost" decision, which raised prices.

In the context of the present debate, it is important to recognize that a regulatory approach which aims to protect consumers from the extraction of rents, while it preserves the stimulus for supply, is entirely feasible. Both the Government Accounting Office and the Energy Information Administration concluded that, even with the distortions of NGPA, rents have been captured and production has been stimulated. If consumers have not been adequately protected and supply responses have not been what was expected, that is the fault of the Commission, not NGPA. NGPA intended to steer producers into the 102 and 103 categories -- conventional new gas with the greatest production potential. FERC actually espoused this concept in its original tight sands decision, but it has done nothing about it. In fact, FERC's distortion of the profitability of Sections 107 and 108 gas mask the relative incentive to produce Sections 102 and 103 gas.

In this fundamental sense, the regulatory approach embodied in NGPA has not been given a fair chance to work -- either for purposes of increasing production or preserving consumer protection. The flaw is not in NGPA; it is in FERC's implementation of the NGPA.

MARKET IMPERFECTIONS AND THE CONTRACTS PROBLEM

With respect to the contracts problem, I argued sixteen months ago that it was the fundamental flaws in the market -- structural and institutional imperfections -- that had created the problem, not NGPA. I stand by my original analysis and will repeat it here, since one of my recommendations is for permanent procedures to address such problems and eliminate these perverse provisions.

Bargaining Power and Contract Provisions

I have a fundamentally different view of the marketplace from than of the Administration.

The Administration looks at the current situation and sees the NGPA price ceilings pushing pipelines to engage in non-price competition to attract supplies. Thus, it identifies these ceilings as the origin of the contracts problem.

I look at the fact that pipelines have Purchase Gas Adjustment (PGA) clauses which can be used to pass through price increases directly to consumers and see absolutely no incentive for them to bargain in the consumer's interest. I look at the close affiliation between producers and distributors and see a serious lack of arms-length transactions leading to a strong interest in price increases.

The Administration looks at the supply side of the market and sees fierce competition and rosy supply prospects. Thus, it predicts a fall in prices upon decontrol.

I look at the fact that the twenty largest producers of natural gas produce more than half our gas and two-thirds of our oil, and see an oligopoly situation with little likelihood of anything but price increases. I look at the restricted access to supplies in the field and see further possibilities of oligopoly profits.

The Administration looks at the one third of the market in which there is significant interfuel substitutability and sees competition at the burner-tip. Thus, it sees no need for consumer protection through regulation.

I look at the two-thirds of the gas market which is captive and see a monopoly situation, creating the potential for unjustified, inefficient monopoly profits.

The flaws that I see in the natural gas market operate at different levels of intensity in different regions of the country and at different moments in time, but taken together they constitute a fundamentally flawed market structure. The fact that FERC has failed to stop transactions at very high prices, even though it has the power to do so, is important. The fact that these transactions occur in the first place is paramount, and it is a direct result of the institutional and structural imperfections in the gas market.

If one recognizes this immensely skewed distribution of market power, it is not surprising to find, as a 1981 study by the American Gas Association did, that 30 percent of all contracts on pre-1973 gas had been renegotiated in a very short period of time to include escalator clauses.

It is not surprising to find, as EIA and GAO studies have, that, for all intents and purposes, the entire industry has indexed its prices to that of number two oil, not the market in which retail gas distributors compete -- which is number six oil -- but the market in which major integrated oil companies maximize their profits. The almost lightening speed with which these contract provisions worked their way into every nook and cranny of the industry and the snail's pace at which a very few of them have been modified, testifies to the maldistribution of the chips in the bargaining process.

Non-competition and Price Behavior

With respect to the potential for monopoly and oligopoly rents, I threw down a simple challenge which bears repeating, since it provides the most compelling basis from which to reject the Administration's proposal.

The best proof that these market imperfections persist is the very fact that gas prices have not fallen in recent months, I said. FERC only sets ceiling prices. It does not set floor prices. If there were competition in the market, then today, when supplies far outstrip demand -- even with FERC's handling (or mishandling) of NGPA -- prices should be falling. They are not.

In the 16 months since I testified, has anything happened in the natural gas market to cast doubt on this assessment? Quite the contrary. There has been little relief in the contractual arena. Contract negotiations have gone nowhere. A few pipelines have tried to claim force majeure as markets collapsed and producers have sued. FERC has taken no steps to quell these perverse bidding and contracting practices.

An even more powerful indictment lied in the response of natural gas prices to the deepest recession since the Great Depression. The demand for natural gas and oil have plummeted. In response to the recession-induced decline in demand, crude oil prices have fallen about 10 percent. About 1.5 trillion cubic feet of industrial demand for natural gas has been lost (.5 trillion cubic feet permanently) and three trillion cubic feet of excess supply has developed in the natural gas market. Did the free negotiations between producers and pipelines change the contract terms which were propping up prices? Did those immense downward pressures have any effect on prices? Not at all. With oil prices falling and inflation running at 4 percent, natural gas prices have increased by over 20 percent.

The natural gas supply industry has played a one hundred billion dollar game of chicken with the American consumer and the American Congress, and I firmly believe that it has lost. It has simply failed, in spite of these immense pressures, to alter contracts or lower prices significantly. It has mobilized every ounce of market power that it possesses to create a nightmare in the hope that it could force an end to all federal regulations.

In the process of doing so, it has proven just how imperfect and skewed the natural gas market is. In the process of doing so, it has put the lie, in advance, to the Administration's proposal for ending the nightmare.

We are told that by guaranteeing the major oil companies between $20 and $40 billion in economic rents on flowing gas and promising them no restraint on the extraction of oligopoly and monopoly profits after January 1, 1986, we will somehow force them to do what they have been unwilling to do for the last two years, when there has been much more pressure on them. It just doesn't wash. Sixteen months ago the talk was about simply erasing the phantom natural gas cushion by letting the producers capture the rents on flowing gas. Today the talk is about erasing the natural gas cushion and the contracts problem.

What I said then applies even more so today.

Without addressing the other structural and institutional imperfections in the marketplace, you simply create a condition in which the whole series of non-competititve transactions will be re-created at a much higher average price level. This means that the upper end of the price spectrum might come down a bit, but the average would move up sharply. Consumers would therefore be worse off than today.

THE SOLUTION TO THE PROBLEM

Whereas 16 months ago I concluded that Title I of NGPA could be implemented by a vigorous and conscientious regulatory Commission to achieve its goals, I am now convinced that FERC has done such a fundamental injustice to the Congressional intention of that Act that it must be retooled. The balance that NGPA tried to achieve between consumer protection and supply-side stimulation can still be achieved:

1. Old gas must not be decontrolled or it would capture about half of the economic rents that are likely to be available on natural gas production through the end of this decade.
2. Indefinite price escalators -- which use other forms of energy as a referent -- and most-favored nation clauses -- which refer to other gas prices -- must be abolished. This cross-referencing of prices violates the very essence of competition at the wellhead and the burner tip.
3. Take or pay clauses must be set at levels necessary to do what they were intended to do -- provide stable finance for the industry. They must not be allowed to be used to bid for gas or to ensure

producers of unjustified profits.

4. All automatic pass throughs must be permanently eliminated to remove the insulation of pipelines from the consequences of their bidding practices.

5. The discretionary powers that FERC has used to push up the price of gas must be abolished and the damage that it has done must be corrected. Unless this is done, the perverse incentives that FERC has created will continue to distort the supply-response, extracting rents from consumers.

6. The rapid increase in inflation over the first several years in which NGPA was in place have distorted the price increase formulae, in addition to creating extremely large price increases. These must be rolled back and only much smaller annual price increases must be allowed.

7. The definition of fraud and abuse that FERC has been allowed to apply under NGPA has proven totally inadequate to protect consumers. Therefore, we must return to the "just and reasonable" standards of the Natural Gas Act.

It is of paramount importance to stress the fact that the Administration package is not consumer protection.

It is not consumer protection to give a blank check to the very same parties who created the problem in the first place and who have been unable to solve it in more than two years when downward pressures on price have been intense.

It is not consumer protection to decontrol old gas and allow it to rise to the world-market oil price, when that gas has been flowing for decades and costs nickles to produce.

It is not consumer protection to place gas prices at the mercy of the Federal Energy Regulatory Commission, when consumers are completely unrepresented on it and the Commission has used all of its discretionary power under the Natural Gas Policy Act to raise prices.

It is not consumer protection to impose a three year moratorium on abusive contract practices, without addressing any of the underlying structural causes of those practices.

It is equally important to stress the fact that the Administration's solution is not an economically efficient solution.

The transfer of economic rents to and the extraction of non-competitive profits by the natural gas producers, especially the majors who own the majority of the old gas, will simply drain more resources away from other sectors of the economy that are in desperate need of capital and consumer spending. It will create a natural gas price drag on the economy, at the very moment that the oil price drag of the second energy price shock has finally begun to work its way out of the system.

To allow politically-manipulated oil prices set the price of natural gas, as the Administration's proposal would do, is to give up all hope of allocating our economic and energy resources in a manner that is consistent with the economic forces, values and needs of our domestic economy.

Only through the measures we propose can we ensure that the price of gas will be driven by the competitively determined costs of production, thereby achieving both consumer protection and national economic efficiency.

I appreciate this opportunity to testify before you today and would be happy to work with the Committee as you grapple with seeking equitable solutions to these problems.

CONSUMER ENERGY COUNCIL OF AMERICA

MEMBER ORGANIZATIONS

Adams Electric Cooperative, Inc.
AFL-CIO
Allegheny Electric Cooperative, Inc.
Amalgamated Clothing & Textile Workers Union, AFL-CIO
American Federation of State, County & Municipal Employees, AFL-CIO
American Federation of Teachers, AFL-CIO
American Public Power Association
Association of Illinois Electric Cooperatives
Association of Texas Electric Cooperatives Inc.
Basin Electric Power Cooperative
Central Power Electric Cooperative, Inc.
Citizen/Labor Energy Coalition
Consumer Federation of America
Cooperative League of the USA
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Florida Electric Cooperatives Association
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Washington State Labor Council, AFL-CIO
Wisconsin State AFL-CIO

THE PAST AS PROLOGUE I

THE UNDERESTIMATION OF PRICE INCREASES IN THE DECONTROL DEBATE:

A Comparison of Oil and Natural Gas

Prepared by:

CONSUMER ENERGY COUNCIL OF AMERICA
RESEARCH FOUNDATION

February 18, 1982

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THE PAST AS PROLOGUE I

THE UNDERESTIMATION OF PRICE INCREASES IN THE DECONTROL DEBATE:

A Comparison of Oil and Natural Gas

Introduction

One of the most critical issues in estimating the impact of energy price decontrol decisions is the projection of the magnitude of the price increase that will flow from each policy alternative. The size of the price increase determines the impact of decontrol on the economy and on the distribution of national wealth (equity). In other reports, the Consumer Energy Council of America Research Foundation (CECA/RF) analyzes the economic and equity impacts of rising energy prices. This report focuses on the issue of making realistic price projections. This must be the starting point for any impact analysis.

It should be noted at the outset that predicting energy price changes as a result of decontrol is an "iffy" business. Due to the fact that many unpredictable variables affect energy prices, projections typically have a wide margin of error. Moreover, matters are made worse by the fact that those who support decontrol of energy prices are likely to underestimate price increases; by the same token, those who oppose decontrol are likely to overestimate them. The combination of genuine uncertainty in the energy market and self-interested bias in much of the data makes it extremely difficult to sort out the good from the bad price projections.

Fortunately, however, we no longer have to approach energy price predictions in a vacuum. Over the past decade three different administrations have made energy decontrol decisions. There is a record of the predictions made prior to those decontrol decisions and the reality of the price increases that resulted from decontrol. By comparing the two, we can glean at least some idea of the magnitude of error in each set of predictions. Further, if the errors can be related to logical or systematic factors, our ability to predict future prices will be improved by analyzing and studying them. In particular, we can learn which assumptions appear to be most appropriate for making predictions.

In this report the Consumer Energy Council of America Research Foundation examines the track record of previous oil decontrol decisions and draws some implications for the analysis of natural gas decontrol.

The Track Record of Oil Decontrol

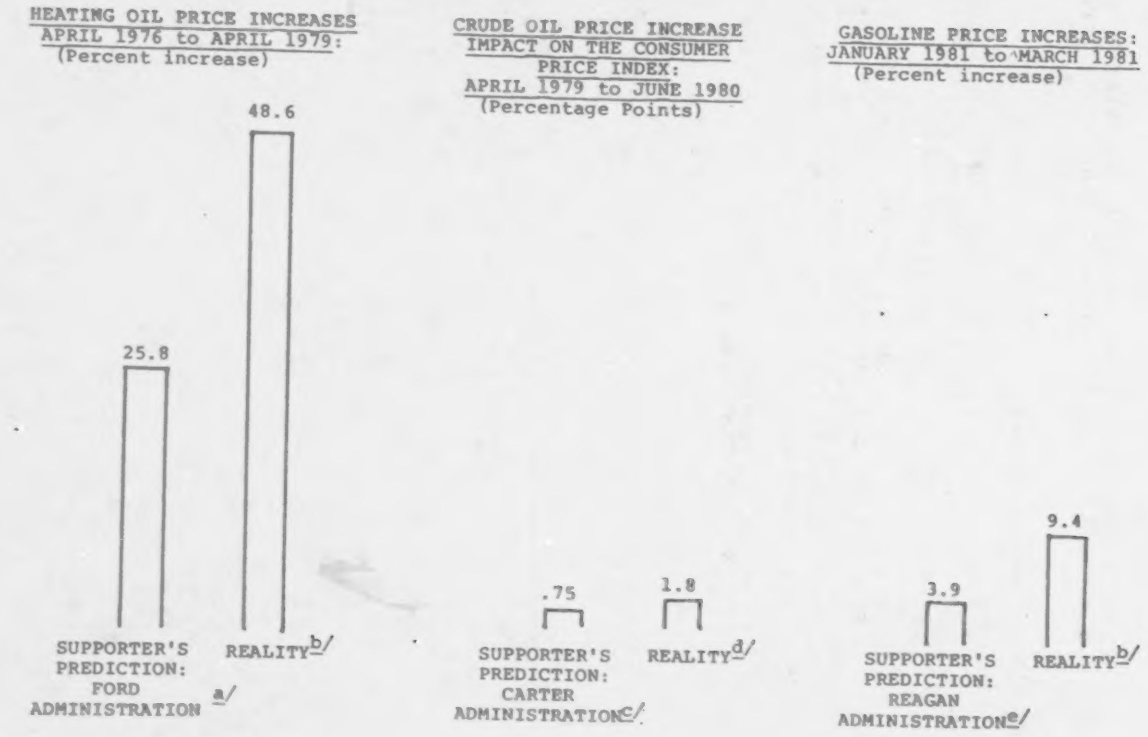
In 1976, the Ford Administration decontrolled heating oil prices. In 1979, the Carter Administration initiated the phased decontrol of crude oil prices. In 1981, the Reagan Administration finalized the decontrol of gasoline prices. (Actually, the Reagan Administration finalized the phase-in of crude oil price decontrol, but, since gasoline was the only controlled product at that time, in effect it decontrolled gasoline prices.) On each occasion a prediction was made about the price increase and/or the inflationary impact that would ensue. As Figure 1 shows, the record of those predictions is uniformly dismal. Predicted price increases were about one-half of the actual increases. Below CECA/RF examines the basis for the predictions and/or their errors in order to gain an important insight into energy pricing behavior.

Carter's Failure

The Carter Administration's failure to predict the impact of decontrol can be partly attributed to the erratic behavior of foreign oil prices, although one should not discount the role of domestic/ multinational oil corporations in paving the way for the supply shortage of 1979.[1] Nevertheless, a great deal of the rhetoric surrounding crude oil decontrol was that competitive pressures and the release of market forces would moderate price increases.[2] These forces certainly did not provide much price protection and one must question whether, in fact, they exist at all. However, because foreign oil prices were rising rapidly, the decontrol of crude oil under President Carter does not serve as a good test of whether market forces can moderate price increases in energy markets. On the two other occasions of oil decontrol, however, the errors in prediction cannot be attributed to foreign price increases.

FIGURE 1

COMPARING PREDICTED AND ACTUAL PRICE INCREASES ASSOCIATED WITH THE VARIOUS STAGES OF OIL DECONTROL



SOURCES: See following page

NOTES TO FIGURE 1

[a] Gorman Smith, "Hearings," Committee on Interstate and Foreign Commerce, H.R. Doc. No. 9121-131 (June 22, 1976), p. 38.

[b] MER, various issues.

[c] "Testimony of Charles L. Shultze, Chairman, Council of Economic Advisors, before the Joint Economic Committee, Subcommittee on Energy, U.S. Congress, April 25, 1979.

[d] Congressional Budget Office, letter from Alice M. Reinlin to Senator Edward M. Kennedy, "Impact of Enerlgy Prices and Inflation on American Families," hearings before the Subcommittee on Energy of the Joint Economic Committee, Congress of the United States, July 8, 1980.

[e] Wall Street Journal, "Decontrol of Oil Prices Expected Today," January 28, 1981.

Ford's Failure

The Ford Administration predicted that heating oil prices would go up by no more than the increase in the price of crude oil after they were decontrolled in May 1976.[3] That is, whatever happended to crude oil prices would happen to heating oil prices as well. Here there can be no question of external price shocks. The argument put forward at the time was that competition would prevent heating oil producers/distributors from raising prices higher than the increase in crude oil costs. The Administration contended that distributors of heating oil would compete both with one another and with alternative fuels to preserve and expand their markets. Therefore, they would put pressure on producers to hold the price of heating oil down. In fact, the oil industry found some way to create price increases twice as large as the crude oil increases.[4]

Analyses of the increases in heating oil prices in excess of the increase in crude prices show that between one-fifth and three-quarters of the increment was due to something other than increases in production or operating costs.[5] In other words, there appeared to be increases in profit margins. Thus, competitive pressures had once again failed to keep prices down. On the contrary, decontrol in the absence of competitive pressures seems to have enabled producers and refiners to increase their profits.

Reagan's Failure

In January 1981, the Reagan Administration finalized the decontrol of gasoline with the assurance that gasoline prices would rise, at most, by five cents a gallon.[6] The administration contended that competition at the pump would keep prices down. However, within less than two months, the actual price increase was more than double that amount.[7] Nothing unusual was going on in the world oil market at that moment -- in fact, prices were declining slightly and there were no regulations to blame, since oil was now completely decontrolled. Yet, prices went up by more than 12 cents a gallon.

Here it is important to address a myth that has grown up around the Reagan gasoline decontrol action of January 1981. The supporters of decontrol are fond of pointing out that after gasoline prices peaked in March 1981, they declined by 2.2 percent through October. A great victory for decontrol is claimed. The claim does not stand even a modest degree of scrutiny.

First, between May 1979, the month before decontrol of crude oil began, and March 1981, when gasoline prices "peaked," prices had risen by 60 cents a gallon (from $.791/gallon to $1.388/gallon). It is hardly a major victory if prices then drop by 3.5 cents or about one twentieth of the increase of the previous two years. Market forces cannot be very strong if it takes a near doubling of prices to get them to move downward a fraction.

Second, the fall in prices observed in 1981 seems to have been totally unrelated to decontrol. The year before Reagan's decontrol action, gasoline prices fell by 2 percent from their peak in July 1980 to their floor in November 1980 (see Figure 2). In fact, prices had been quite stable throughout the latter part of 1980, prior to Reagan decontrol. The Reagan decontrol action seems to have enabled gasoline prices to jump 12 cents, then follow their usual pattern of seasonal moderation. A careful look at the history of gasoline prices shows that in 1975, 1976, 1977, 1980 and 1981 there was a decline in gasoline prices -- ranging from 1 to 3 percent -- between their peak in the summer and their valley in the following winter.[8] The pattern appears to be seasonal rather than being related to decontrol. Thus, the victory that is claimed for decontrol is an illusion.

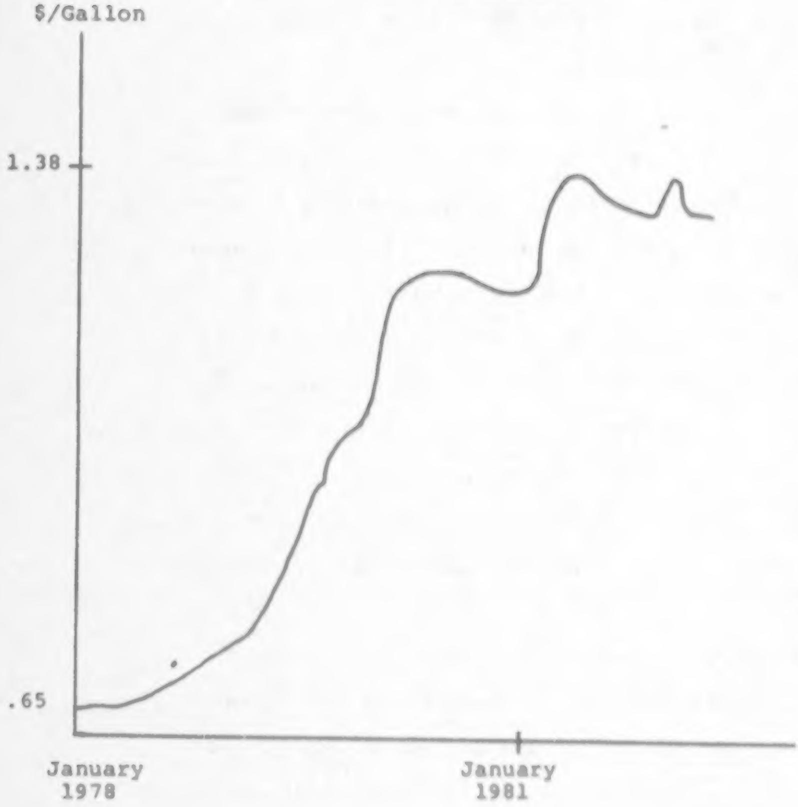
It appears that both Republican and Democratic administrations had seriously overestimated the strength of competitive and market forces and seriously underestimated the ability of the domestic energy industry to impose price increases in excess of what a competitive situation would have allowed.

Natural Gas Price Projections

Against this track record, the current flurry of predictions about natural gas decontrol is most interesting. Figure 3 presents a number of recent projections of the

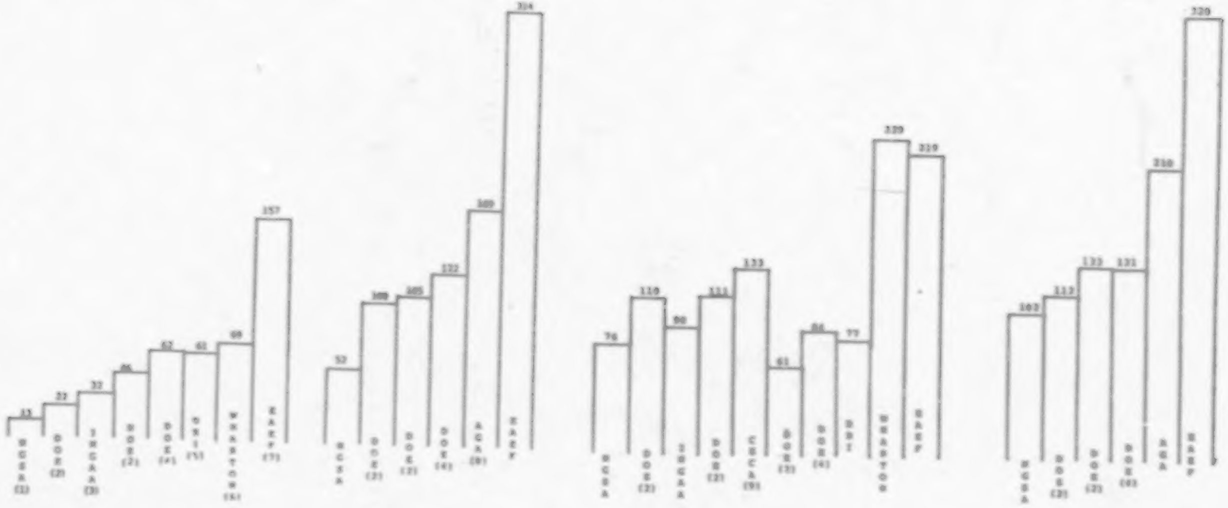
FIGURE 2

GASOLINE PRICES
1978-1981



SOURCE:
U.S. Department of Energy, Monthly Energy Review, various issues.

FIGURE 3
PRICE INCREASES PROJECTED AS A RESULT OF NATURAL GAS DECONTROL



PERCENTAGE REAL PRICE INCREASE IN THE FIRST YEAR AFTER DECONTROL

ACCELERATED DECONTROL

FULL DECONTROL

PERCENTAGE REAL PRICE INCREASE IN THE FIRST THREE YEARS AFTER DECONTROL

ACCELERATED DECONTROL

FULL DECONTROL

SOURCES:
See following page

NOTES TO FIGURE 3

[1] Glenn C. Loury, An Analysis of the Efficiency and Inflationary Impact of the Decontrol of Natural Gas Prices, (Natural Gas Supply Association [NGSA], April 1981). Full decontrol is Scenario 4. Accelerated decontrol is Senario 6. The latter is tantamount to a four year phase-in.

[2] U.S. Department of Energy, Two Market Analysis of Natural Gas Decontrol, Attachment 3, November 1981.

[3] Interstate Natural Gas Association of America, Analysis of Natural Gas Decontrol, December 1, 1981. Case J, which is the scenario preferred by INGAA (see Supplemental Statement on Behalf of the Interstate Natural Gas Association of America, Senate Committee on Energy and Natural Resources on the Implementation of Title I of the Natural Gas Policy Act, December 1, 1981).

[4] U.S. Department of Energy, Reducing U.S. Oil Vulnerability: Energy Policy for the 1980's (November 10, 1980), Chapter II.

[5] Mary H. Novak, "Natural Gas: Should the NGPA Be Reopened," Data Resources Inc., Spring 1981, Decontrol-1982 Scenario.

[6] Wharton Econometric Forcasting Associates, cited in Dun's Business Month, November 1981, p. 56.

[7] Energy Action Educational Foundation, The Decontrol of Natural Gas Prices: A Price American's Can't Afford (February 19, 1981).

[8] The American Gas Association, Cost of Immediate Total Wellhead Price Decontrol of Natural Gas to Low Income and Disadvantaged Groups, April 9, 1981.

[9] See Appendix A.

increase in average wellhead prices in the first year and the first three years following both accelerated decontrol and full decontrol. The range of estimates is extremely wide. The highest estimate for the first year increase under an accelerated decontrol scenario is more than ten times as large as the lowest. For full decontrol, the highest estimate of the first year increase is six times as large as the lowest. Estimates of the three year increases do not vary as widely. The highest estimated increase for accelerated decontrol is 3.7 times that of the lowest, while under full decontrol the highest estimate is 3.6 times the lowest.

Full decontrol and the three year accelerated decontrol estimates are probably better gauges of the differences of opinion about likely price increases than the estimates after just one year of accelerated decontrol. This is the case because the various accelerated decontrol scenarios which CECA/RF has reviewed are based on somewhat different assumptions about which categories of gas will be decontrolled and what the pace of decontrol will be. However, the accelerated scenarios begin to converge in the third year in terms of the quantities of gas decontrolled and the ceiling prices allowed, so that these price estimates are based on roughly comparable conditions.

As Figure 3 shows, supporters of decontrol (for example, the Natural Gas Supply Association [NGSA] and the Reagan Administration) project price increases that are one-half to one-third those of opponents of decontrol (the American Gas Association [AGA] and Energy Action Educational Foundation [EAEF]). Here the experience of prior oil and oil product decontrol actions is most instructive. Actual price increases generally have been 2 to 2> times larger than the price increases predicted by the various supporters of decontrol. Thus, based on recent history and the pattern of projections, it is a safe bet to assume that actual price increases will fall midway between the high and low estimates.

Splitting the difference is not simply a numbers game. Differences in price projections need not stem from blatant biases or erroneous calculations. In fact, it is easy to construct technically correct explanations for each set of predictions, i.e., explanations whose reasoning is correct, once their assumptions are granted.

Those who project low price estimates tend to assume 1) intense competition between suppliers leading to relatively elastic supply and 2) significant discretionary use of energy or easy substitution of capital for energy or easy switching between fuels, leading to relatively elastic demand. In short, there is an assumption that competitive market forces on both the supply and demand sides would keep prices down.

Those who project high price estimates tend to assume 1) much less competition between suppliers and 2) much less elasticity of demand. Simply put, there is an assumption that competitive market forces are weak and prices could run up sharply after decontrol.

In Appendix A, CECA/RF develops a detailed example of the behavior of the natural gas market under assumptions of restricted competition and inelastic demand based on the most recent analysis of the natural gas market developed by the Department of Energy.[9] The CECA/RF analysis shows that altering DOE's assumptions about competition and demand elasticity can lead to a predicted price of gas 15 percent higher than DOE's estimates in Figure 3. That would put the estimate of price increases close to twice as high as NGSA's.

For present purposes, let it suffice to say that one approach to take in resolving a difference of opinion about the state of competition in the market would be to observe the market in order to ascertain which set of assumptions best fits reality. Economists are fond of identifying those characteristics of the market which theoretically determine the level of competition (e.g., concentration ratios) and then calculating them for each energy market. However, prior research in this regard has not been conclusive. Another, more direct and empirical approach is to look at the history of price behavior subsequent to recent decontrol decisions. Rather than rely on some theoretical notion of what the market should do, CECA/RF charts what it has actually done in the recent past. Past predictions, which assumed highly competitive conditions, have been off by a factor of two.

And they are likely to be off in the future -- also by a factor of two.

Price Increases and Economic Impacts

As mentioned in the introduction, the concern over the magnitude of price increases has two points of real significance. That is, there are two major reasons why we worry so much about price increases. One reason involves the equity of price increases. When prices go up -- especially on domestically produced commodities -- some Americans lose and some gain. The higher the increases, the bigger the losses. The second reason involves the impact of price increases on general economic activity. When prices go up, economic activity tends to be reduced. If price projections are off by a factor of two, the estimation of impacts will be off as well. Each of these issues will be dealt with in separate reports by CECA/RF.[10] However, in the context of the history of price projections and price realities one important observation can be offered at this point that deals with the linkage between price increases and economic impacts.

One of the arguments being made in support of accelerated decontrol of natural gas is that it will avoid a "price shock" and therefore moderate the economic impact of rising prices. The severe disruptions associated with the oil price shock of 1979-80 are frequently the point of reference. That is, those who support phased accelerated decontrol think they can avoid a price shock similar to that of 1979-80, which occurred for oil. If that is the frame of reference, then the argument that accelerated decontrol of natural gas will cushion the economic blow is largely unfounded.

The pattern of price increases that will occur under accelerated phased decontrol of natural gas is very similar to the pattern of price increases that actually occurred during 1979-81. Although the causes of the crude oil price increases in 1979-80 are different than the causes of the projected natural gas price increases, the actual patterns of increases and their likely economic effects are similar and this is a point of overwhelming importance. Let us review each pattern of price increases in turn.

The oil price shock is commonly associated with an event, the Iranian revolution, and a subsequent rapid increase in crude oil prices. From the point of view of the domestic economy, however, this conception is completely wrong. For six months after the Iranian shutdown of January 1979, 70 percent of all domestic crude oil was under price controls.[11] In June 1979, the phased decontrol of domestic oil began. The net effect was not that crude oil prices jumped instantaneously; rather, they rose in a rapid, but steady fashion. There was no single price shock; there was a phased run-up in prices.[12] Specifically, between January 1979 and October 1981, refiner acquisition costs for crude oil increased from about $2.26 per million Btu ($13.11/bbl) to $6.02 per million Btu ($34.93/bbl). The average monthly increase (compounded) was 3.3 percent. The actual month by month increases in prices were fairly even -- the average increase was 3.7 percent per month and 17 of the 29 monthly changes represented increases of between 2.1 percent and 7.2 percent. This is the price pattern that produced the negative economic impacts associated with the oil price shock.

Now let us contrast that historical record with the price trajectories projected for accelerated decontrol of natural gas. The price trajectory of natural gas decontrol will reflect two factors. Some gas will be decontrolled immediately (the most frequently discussed categories are all gas discovered after January 1, 1982 (referred to as "new-new gas") or all gas discovered after January 1, 1977 (referred to as "all new gas"). The remainder of the gas (referred to as "old gas") will be decontrolled in a phased fashion over a period of between 24 and 60 months, depending on which scenario is chosen and which categories are included.

According to the high and low estimates presented in Figure 3, the price trajectory that would result from decontrol is as follows: natural gas prices would go from about $2.30 per million Btus in January 1982 to a price between $7.00 and $8.50 per million Btus in January 1986. The average monthly price increases (compounded) would be between 2 and 3.3 percent. There would be a surge in the first year when monthly price increases would be between 3 and 4.2 percent (compounded). The highest price projection leads to a rate of increase in gas prices that is about 18 percent faster than that which occurred for oil. The low price projection leads to a rate of increase that is roughly 32 percent slower than the increase for oil. If reality falls between the two, one would expect a pattern of price increases that is quite close to that which occurred during the oil price shock. Such a pattern would mean that prices would increase at exactly the rate which occurred during the oil price shock.

To the extent that energy price increases present problems of structural adjustment in the economy (as opposed to simple surprises for which the economy is unprepared), not much relief can be expected from accelerated decontrol. Those structural problems and the magnitude of the impact of price increase will be the topic of another report in this series, but it is clear that the supporters of decontrol are mistaken if they believe that phased decontrol will cushion the blow.

Summary and Conclusions

In this report we have examined the history of price projections and the price realities that surround energy price decontrol decisions. We have found that, in the case of oil-related decontrol, the supporters grossly underestimated the increase in prices that occurred. Insofar as they repeatedly argued that competition would hold prices down, their dismal record of price projections suggests that competitive and market forces are weak.

Turning to the current projections of the impact of natural gas decontrol, we find a wide difference of opinion. The supporters of decontrol predict price increases one-third that of the opponents. If history is a guide, one can expect that the actual price increases will be twice as large as those predicted by the supporters.

Finally, we have examined the pattern of price increases that occurred during the "oil price shock" of 1979-80. We find the accelerated phased decontrol of natural gas will create a trajectory of price increases that is quite similar to that which occurred during the oil price shock. This clearly suggests that phasing-in decontrol will not avoid the severe negative economic impacts of rising energy prices that occurred during the oil price shock.

FOOTNOTES

[1] Official accounts absolve the major oil companies of all responsibility (see, for example, *The Report of the Department of Justice to the President Covering the Gas Shortage of 1979* [Washington, DC: Goverment Printing Office, July 1980]) but there is ample evidence of their involvement (see *Roots, Realities, Responsibilities: How the Major Oil Companies, Not OPEC, Tightened Oil Supplies and Initiated Price Hikes in 1978 and 1979* [Energy Action Educational Foundation, May 1980]).

[2] See, for example, "Testimony of Charles L. Shultze, Chairman, Council of Economic Advisors," before the *Joint Economic Committee, Subcommittee on Energy*, U.S. Congress, April 25, 1979.

[3] See, for example, testimony of Gorman Smith, before the U.S. Congress, Committee on Interstate and Foreign Commerce, H.R. Doc. No. 914-131 (June 22, 29, 1976), p. 38.

[4] U.S. Department of Energy (DOE), *Monthly Energy Review*, various issues.

[5] The lower estimate can be derived from DOE, *Analysis of Refiner No. 2 Distillate Costs and Revenues, July 1976-June 1979*, Tables 9 and 19 (September 1979). The higher estimate can be derived from the Consumer Energy Council of America, "Analysis of No. 2 Distillate Prices and Margins," presented before the U. S. Congress, House, Subcommittee on Environment, Energy and Natural Resources of the Government Operations Committee, February 12, 1980.

[6] See the comments of David Stockman, in "Decontrol of Oil Prices Expected Today," *Wall Street Journal*, January 28, 1981. Some industry analysts asserted that "we would be hesitant to sock on a 10-cent-a-gallon increase at once, the increase could come in stages at a rate a couple of cents a month." Others professed to believe that "almost nothing" would happen due to ample stocks which would face refiners' margins to shrink.

[7] *MER*, various issues.

[8] Ibid., various issues.

[9] U.S. Department of Energy, *Two-Market Analysis of Natural Gas Decontrol* (Washington, DC: Government Printing Office, November 1981).

[10] CECA/RF, "Natural Gas Price Deregulation: A Case of Trickle Up Economics" (January 20, 1982).

[11] The Congressional Budget Office, *The Decontrol of Domestic Oil Prices: An Overview*, May 1979, Chapter II.

[12] *MER*, various issues.

Appendix A

COMPETITIVE VERSUS OLIGOPOLY PRICING OF NATURAL GAS

or

How Big Does the Tail Have To Be To Wag the Dog?

an appendix to

The Past as Prologue I

The Underestimation of Price Increases
in the Decontrol Debate

Prepared by:

CONSUMER ENERGY COUNCIL OF AMERICA

RESEARCH FOUNDATION

February 18, 1982

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APPENDIX A

COMPETITIVE VERSUS OLIGOPOLY PRICING OF NATURAL GAS

or

How Big Does the Tail Have To Be
To Wag the Dog?

A. Introduction

The review of the recent history of the behavior of energy prices presented above has shown that history has been extremely unkind to those who assume that energy markets are highly competitive. Actual price increases have far outstripped their predictions, calling into question the soundness of the competition assumption. The review of natural gas decontrol price projections presented in "Past as Prologue I" has shown wide differences and we have suggested that these differences in price projections can be explained logically by differences in assumptions with respect to the extent of competition in the market. In this Appendix, we demonstrate that differences in assumptions can be translated empirically into differences in price projections.

Unfortunately, few of those who actually make the projections bother to present and defend their assumptions or to analyze what the impact of alternative assumptions would be. Above all, because price predictions tend to be highly political, most of those who make them are not at all inclined even to consider alternative assumptions that touch on matters as basic as competition. Moreover, most studies do not contain an adequate basis for undertaking such analyses. Thus, most studies simply state their assumptions and derive their conclusions without gathering evidence or demonstrating that supply and demand (either competitively or non-competitively) will reach equilibrium at the particular price they believe is correct.

The recent study by the Department of Energy[1] does have the necessary elements for considering alternative assumptions about competition, although DOE did not conduct such an analysis. In fact, DOE assumes a level of competition that is identical to the assumptions made by the gas producing industry and never questions these assumptions. Because the DOE study is likely to be of considerable importance in present and future decontrol debates, because it is one of the few with the necessary analytic elements, because DOE has blindly assumed competition, because recent price history has suggested an absence of competition, and because we believe that there is a considerable body of evidence to justify some skepticism of the assumption of a high degree of competition in the natural gas market,[2] this technical appendix compares the expected price under the assumptions of competition to the expected price under the asssumption of non-competition in the market.

B. Competition vs. Non Competition

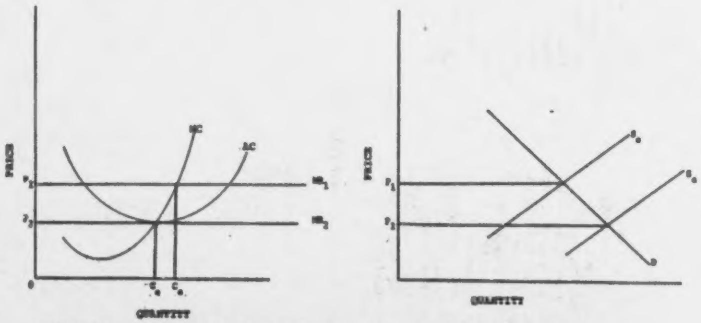
The basic tools needed to analyze pricing behavior under assumptions of a lack of competition can be found in the most elementary of economics texts. Figures A.1 and A.2 provide two simple discussions of why monopoly or oligopoly market conditions lead to lower quantities supplied and higher prices than competitive conditions. For those unfamiliar with the basic concepts, a careful reading of the explanations accompanying the figures will be helpful.

The essence of the argument rests on the demand curve which individual suppliers face. In a competitive situation, each supplier faces perfectly elastic demand and marginal revenue curves, since if the supplier raises prices above the market price, the supplier would lose his/her business to his/her competitors. Monopolists or oligopolists do not face perfectly inelastic demand curves. As they raise their prices, they lose only part of their business; since fewer competitors threaten their demand, their loss of demand is relatively small. They are willing to lose demand, as long as they increase profits by doing so. That is, they keep raising prices, even though they are losing business, because they make more profits by selling less at higher prices. In fact, all suppliers maximize profits at the point where marginal revenue equals marginal cost; but oligopolists maximize profits at higher prices and lower quantities supplied than those who face competition because they face a less than perfectly elastic (i.e., downwardly sloping) demand

FIGURE A.1

PRICE AND SUPPLY UNDER ASSUMPTIONS OF COMETITION AND MONOPOLY

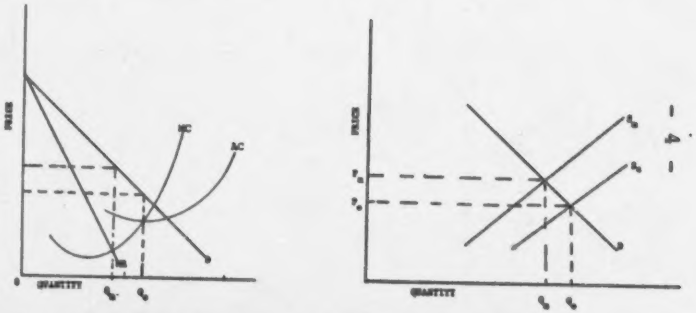
COMPETITION AND EFFICIENCY



At the market price of P_1, the firm chooses a level of output, $C_{e'}$, where MR = MC. Since P is above AC, profits are earned. Entry occurs, pushing the market supply curve out to the right, and market price decreases. When market price falls to P_2, entry will cease. For the firm, MR = MC at C_e (so profits are "maximized," the firm does the best it can given the circumstances); and there are no profits, since AC=P! The cost per unit produced is equal to the price the firm gets per unit sold. Revenues just cover costs. However, remember that costs include opportunity costs for the firm! Even though no economic profits are earned at this level of output, the firm still gets enough revenue to cover its opportunity costs (normal profits). So the firm will remain in business. But note what has happened. Due to competition and free entry, the firm has been forced to produce at that level of output that minimizes average cost!

Source: Tom Ridell, Steve Stamos and Jean Shackleford, Economics: A Tool for Understanding Society (Reading Mass.: Addison Wesley, 1979) pp. 167, 177-178.

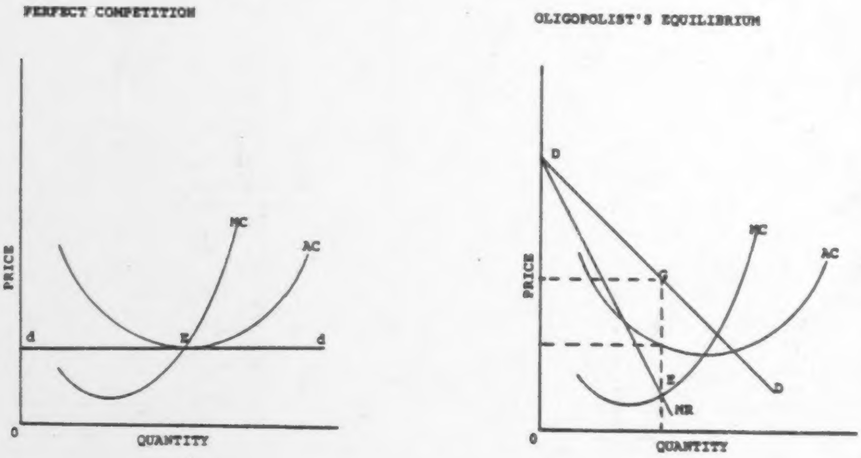
MONOPOLY OUTPUT RESTRICTION AND HIGH PRICE



What level of output will the monopoly choose to produce? It will produce Q_m, where MC = MR, because that level of output maximizes its profits. It will charge a price of P_m for that amount of output, because that is the price the market is willing to pay for that quantity. The monopoly is earning profits since P is well above AC. And the monopoly is producing at a rate of output that does not minimize average costs (Q_c is where AC is at a minimum). However, in a monopoly, when profits are being earned, there is no entry into the market, because there are no competitors. We can examine the theoretical results of this by focusing on the (aggregate market). If there were competition in the market, new firms would enter, market supply would increase to S_c, and market price would decrease to P_c. Thus, monopoly restricts output, since $Q_m < Q_c$. And monopoly charges higher prices, since $P_m > P_c$. Finally, monopolies earn monopoly profits. An important conclusion that can be drawn from the monopoly model is that the existence of market power (ability to control supply and price) tends to prevent the occurrence of consumer sovereignty, the attainment of economic efficiency, and the operation of the invisible hand. The monopoly benefits at the expense of the society.

FIGURE A.2

PRICE UNDER ASSUMPTIONS OF COMPETITIVE AND OLIGOPOLY BEHAVIOR



PERFECT COMPETITION

OLIGOPOLIST'S EQUILIBRIUM

SAMUELSON OFFERS THE FOLLOWING DISCUSSION OF THE TWO SITUATIONS:[a/]

> This typical perfect competitor is one of so many producers of an identical good that he/she faces a practically horizontal (infinitely elastic) demand (dd) curve, even though the industry's very much larger DD curve can be much more inelastic. If there is free entry and exit of well-informed firms who can replicate the cost conditions of any other firm, long-run equilibrium at E will involve no excess of profit over competitive costs (including properly computed implicit opportunity cost returns). Society is getting its total output most efficiently, in recognition of the P=MC condition, both in long and short runs. It is not forcing out of existing firms any output that could be obtained more cheaply by adding new firms.

> After experience with disastrous price wars, each of the few rivals that dominate a given market is almost sure to recognize that price cutting begets cancelling-out price cutting. So the typical oligopolist will estimate his/her demand curve DD by assuming others will be charging similar prices (and by taking into account the potential entry of other oligopolists). Since he/she gains little from extreme cutting of P, he/she will settle for sizable markup of P over MC.

[a] Paul Samuelson, Economics (New York: McGraw Hill, 1980), pp. 482, 485.

curve. This basic concept underlies all discussions of pricing under non-competitive conditions.

Thus, in order to estimate natural gas prices under either competitive or non-competitive assumptions, we must estimate the supply, marginal cost, demand, and marginal revenue curves.

C. The DOE Assumptions

1. The Basic Approach

The Department of Energy and the gas producing industry assume a partially competitive market. They assume that a price ceiling on natural gas is set by some alternative fuel. That is, they assume there exists a price above which suppliers of alternative forms of energy (e.g., oil) will be able to steal business from gas producers. Therefore, competition between fuels restrains the price increases of natural gas and sets the market clearing price.

If we assume a ceiling price on gas which is set by competition with oil we can establish a demand curve for gas. When the demand curve is coupled with a supply curve, we can analyze what the market price of gas would be under different assumptions about the pricing behavior of suppliers.

However, it should be noted that the market assumed by DOE is not a perfectly competitive market in the classic sense. DOE does not assume that suppliers of gas can exert significant downward pressure on the price of alternative fuels. That is, gas producers do not steal sufficient oil business by producing more gas at lower prices to force the oil suppliers to lower their prices. The fact that gas suppliers do not try to exert downward pressure on oil prices suggests that perfect competition is not present. This creates the possibility of extremely high profits on natural gas production because natural gas prices need not bear any relationship to the costs of producing natural gas. That is, entry into the energy industry does not occur to wipe out abnormal profits (see Figure A.1 above). Instead of the average price of all forms of energy being driven down to a point where only normal profits exist, DOE assumes that the price of gas rises and yields abnormal profits. In fact, as will be discussed below, DOE's analysis suggests that extremely high rates of profit exist on gas production. These rates of profit would not exist in a perfectly competitive world.

2. The Theoretical Market Clearing Price

The Department of Energy and the gas production industry both assume a partially competitive environment in which the price of gas at the wellhead is set by the cheapest competing fuel. The cheapest competing fuel is assumed to be high sulfur (#6) residual fuel oil used primarily in industrial boilers (including electric utility power plants). Consumers of #6 oil are assumed to set the marginal price both because that fuel is cheapest and because these industrial consumers tend to have the capacity to shift between fuels in the short term. At a minimum, they have adequate incentive to acquire that capacity, thereby threatening to switch fuels if the given price is not competitive. That is, they can or are willing to acquire the ability to burn either fuel at any moment. Therefore, they "play" the energy market to minimize costs.

They install dual fuel-burning capacity partly because they have been low priority "interruptible" users in the past (and have needed dual capacity in order to maintain production operations) and partly because they consume enough energy to make playing the energy market economically justifiable. That is, the volumes of energy they consume are so large that they can cover the costs (including normal profits) of installing dual fuel-burning equipment.

DOE assumes that the wellhead price of natural gas will be equal to the burner tip price of #6 fuel oil minus gas transmission and distribution costs. That is, the price of gas at the wellhead can be no higher than the price of the alternative at the burner tip net of the transmission and distribution costs, i.e., the costs of getting the gas from the wellhead to the burner tip. Recent estimates by DOE show that consumers of high sulfur #6 oil who are potential gas consumers account for less than 4 percent of the aggregate demand for gas (Residual D in Table A.1). However, because they are the marginal users in a competitive framework, they set the wellhead price.

Table A.1

PERCENTAGE DISTRUBTION OF NATURAL GAS DEMAND

Category and Alternative Fuel Type

Alternative Fuel	Residential		Commercial		Industrial Non-Boiler		Electric Utilities		Industrial Boiler		TOTAL[1]
	Inter-state	Intra-state	Inter-state	Intra-state	Inter-state	Intra-state	Inter-state	Intra-state	Inter-state	Intra-state	
Distillate	25.9	3.4	7.3	1.4	3.3	1.5	2.4	.8	.2	1.3	46.5
Residual A	0	0	3.3	.7	10.1	4.9	.7	.2	1.4	2.0	23.3
Residual B	0	0	3.3	.7	1.5	2.6	.9	8.4	.6	1.2	19.2
Residual C	0	0	0	0	1.0	.7	1.3	.2	1.0	1.4	5.6
Residual D	0	0	0	0	.3	.1	.6	.1	1.1	1.4	3.6
Residential ($2.00)	0	0	0	0	.3	.2	.6	.1	.4	.6	2.2

---

[1] Numbers may not add due to rounding.

Source: DOE, Two Market Analysis, p. A-88.

According to DOE, once the wellhead price is set at the margin by these consumers, then the burner tip price can be calculated for all other consumers. This is accomplished by taking the wellhead price and adding to it the transmission and distribution costs that apply to each user. In other words, the entire market is driven by competition at the margin for high sulfur fuel oil users.

If one questions the assumption that suppliers behave as though they were driven by competition to sell every cubic foot of gas that they can, then one must question whether high sulfur residual fuel oil should drive the wellhead price. Such a small percentage of demand may look like a very small tail to be wagging a big dog. Wouldn't producers be willing to lose 4 percent of their demand by raising their price, if the increased price would lead to an increase in total profits?

As we shall see, DOE's evidence suggests that, if producers behave in a non-competitive fashion, they can maximize profits by raising prices well above DOE's theoretical competitive market clearing price and sacrificing as much as 30 percent of the total demand.

The following analysis estimates the demand, marginal revenue and marginal cost curves projected for 1985 based on DOE's recent analysis of accelerated/phased decontrol. Because the data are taken directly from published DOE materials, the analysis embodies DOE's assumptions and relies on considerable interpolation of DOE's results. Nevertheless, it makes the point quite clearly.

D. An Estimation of the Theoretical Market Clearing Price under Competition

1. The Demand Curve

In order to create the demand curve for natural gas, we begin by identifying the quantity of gas demanded by a series of specific categories of users (see Table A.1 above). User categories are identified by (1) the end use to which the fuel is put (residential, commercial, industrial non-boiler, industrial boiler and electric utility), (2) the pipeline market (interstate versus intrastate) and (3) the alternative fuel (distillate, 4 grades of residual oil and the lowest grade [highest sulfur] residual minus $2.00). There are 44 combinations of end uses/pipeline markets/alternative fuels and these are used as data points for the estimation of the demand curve. End use type, pipeline market and alternative fuel are chosen to define the categories of users because they are the most critical determinants of the wellhead price of natural gas that would compete with alternatives at the burner tip.

In the next step, we calculate the wellhead natural gas price that would just capture the business of each user category. That is, we create a second matrix by calculating the burner tip price of the alternative fuel minus the transmission and distribution costs implicit in DOE's analysis for each specific user category (see Table A.2).

Table A.2

The Competitive Wellhead Price of Natural Gas
for Each User Category/Alternative Fuel Combination

Alternative Fuel	Transmission & Distribution Costs	Residential		Commercial		Industrial Non-Boiler		Electric Utilities		Industrial Boilers	
		Inter-State	Intra-State	Inter-State	Intra-State	Inter-State	Intra-State	Inter-State	Intra-State	Inter-State	Intra-State
Distillate	7.13	5.08	5.79	5.36	6.10	6.00	6.69	5.95	6.77	6.16	6.16
Residual A	6.17	na	na	4.40	6.14	5.04	5.73	4.99	5.81	5.20	5.20
Residual B	5.71	na	na	3.94	4.68	4.58	5.27	4.53	5.35	4.74	4.74
Residual C	5.55	na	na	na	na	4.42	5.11	4.37	5.19	4.58	4.58
Residual D	5.36	na	na	na	na	4.23	4.92	4.18	5.00	4.39	4.39
Residual D minus $2.00	3.36	na	na	na	na	2.25	2.92	2.18	2.00	2.39	2.39

Source: DOE, Two Market Analysis, Attachment IV.

The burner tip price of the alternative fuel minus transmission and distribution costs equals the wellhead price that would be just competitive with the alternative.

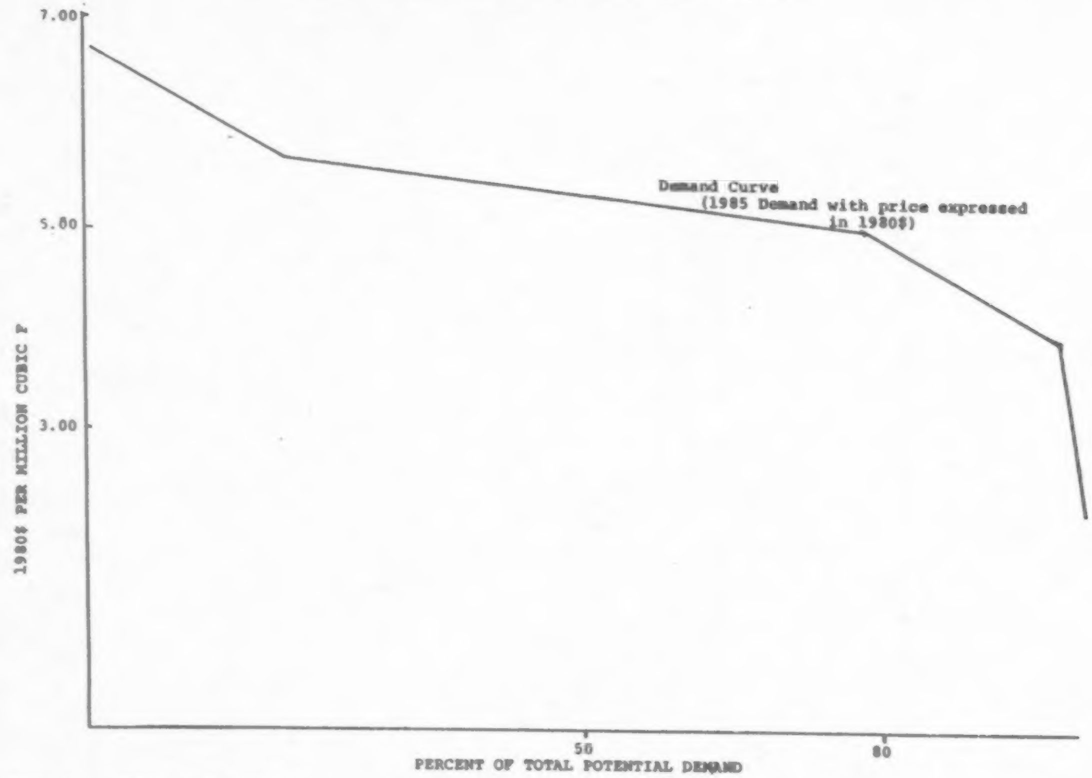
The demand curve that results (see Figure A.3) exhibits a shape that is quite familiar. In fact, it is not unlike the demand curve depicted by DOE in its conceptual discussions of the natural gas market (see Figure A.4). However, the point at which demand becomes inelastic for the second time, the point at which the curve turns down for the second time, occurs at a higher price than in DOE's conceptual curve. The difference in shape is significant for two reasons which will be elaborated below. First, it makes the benefits of oligopoly pricing secure. That is, the benefits are impervious to (or "robust" with respect to) the assumptions made about the shape of the marginal cost curve. Second, it also has major implications for the behavior of the market, even if competition is assumed. The steepness of the demand curve at prices below $5.00 means that the market will not be very responsive to price changes.

2. The Supply Curve

The second curve necessary to calculate the market equilibrium and/or the point of maximum profit for oligopolists is the marginal cost (supply) curve (see Figure A.5). DOE gives 1980 marginal costs in 1980 $/mcf for four categories of domestically produced gas -- associated ("no

FIGURE A.3

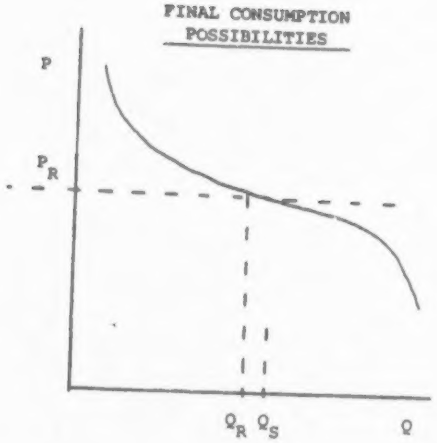
MAXIMUM POTENTIAL NATURAL GAS DEMAND CURVE



Source: Tables A.1 and A.2

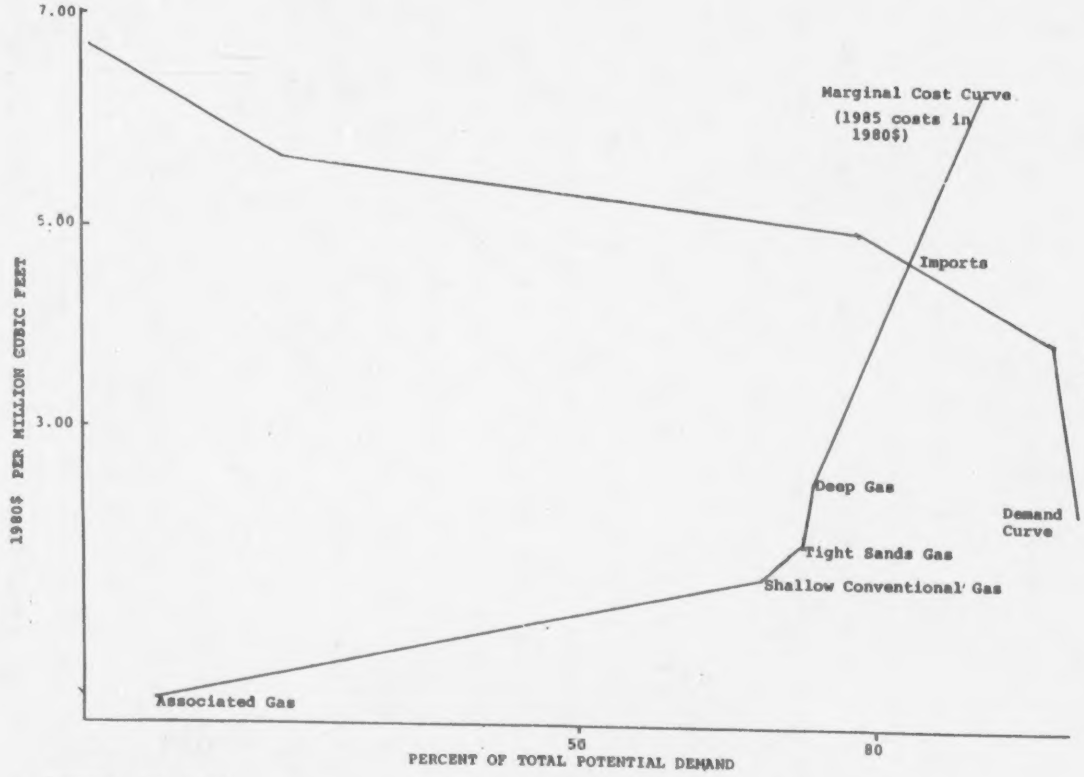
FIGURE A.4

THE DEPARTMENT OF ENERGY'S CONCEPTUAL DEMAND CURVE



Source: DOE, Two Market Analysis, p. A-97

FIGURE A.5
MARGINAL COST CURVE FOR NATURAL GAS



Source: See text

cost"), shallow conventional ($1.24), tight gas ($1.50) and deep gas ($2.15).

Since all prices used to plot the demand curve are 1985 prices stated in 1980 $/mcf, the costs are stated on the same basis for both demand and supply. However, the supply costs are estimated for 1980, not 1985. Therefore, it is necessary to calculate marginal costs for 1985.

Marginal costs will rise over time and DOE assumes they will rise as a function of the declining success rate of natural gas exploration. If success rates change differently for each category of gas exploration, then the shape of the marginal cost curve could change. However, for the base case, DOE assumed a real 2.5 percent increase in marginal costs per year. This leaves the shape of the curve largely unaffected. For the purposes of moving five years into the future, this would appear to be a reasonable assumption. The marginal cost curve shown in Figure A.5 includes this 2.5 percent per year real price increase for the five years between 1980 and 1985.

Here it should be noted that DOE's initial marginal costs for 1980 include an 8 percent real rate of return (normal profits). However, if we compare the initial marginal cost to the actual prices being allowed or paid in the market in 1980, we discover that the rate of return is much higher than 8 percent (see Table A.3). The initial marginal cost estimates imply actual costs (costs before profits are added) of $1.14/mcf for conventional shallow gas,

Table A.3

ESTIMATING IMPLICIT RATES OF RETURN FOR VARIOUS CATEGORIES OF NATURAL GAS

	(1) Initial Marginal (1980$ mcf)	(2) Profit (8% real)	(3) Cost [(3)=(1)-(2)]	(4) Ceiling[d] Price (1980$ mcf)	(5) Production[d] Taxes (7%)	(6) Additional[d] Costs	(7) Net Producer Revenues [(7)=(4)-(5)-(6)]	(8) Implicit Rule of [(8)=(7)-(3)/(3)]
Shallow Conventional[a]	1.24	.10	1.14	2.47	.16	.03	2.28	100
Tight Sands[b]	1.50	.11	1.39	4.92	.32	.03	4.57	229
Deep Gas[c]	2.15	.16	1.99	6.80	.48	.03	6.29	

Source: DOE, Two Market Analysis, as follows:

[a] Weighted average of regional marginal costs in Figure III-6, p. A-20.

[b] P. A-54.

[c] P. A-53.

[d] Attachment 2,p. 2-2.

$1.39/mcf for tight sands gas and $1.99/mcf for deep gas. The ceiling prices allowed for these types of gas imply revenues to producers (i.e., the market price of gas net of severance and other production taxes as well as cost add-ons) of $2.28/mcf for shallow gas, $4.57/mcf for tight sands gas and $6.29/mcf for deep gas (assuming deep gas can get the interstate marginal price that DOE assumes for 1981). The implicit rates of return (before income taxes) are 100 percent for shallow gas, 229 percent for tight gas and 216 percent for deep gas.

These extremely high rates of return are the result of the absence of pressure to drive prices below the effective ceilings which oil prices (and NGPA) allow. As discussed above, the fundamental market process which should drive prices down in a competitive economy -- the free entry of firms willing and able to produce gas at the average rate of return in the economy, thereby lowering the price and the rate of profit -- is obviously not working.

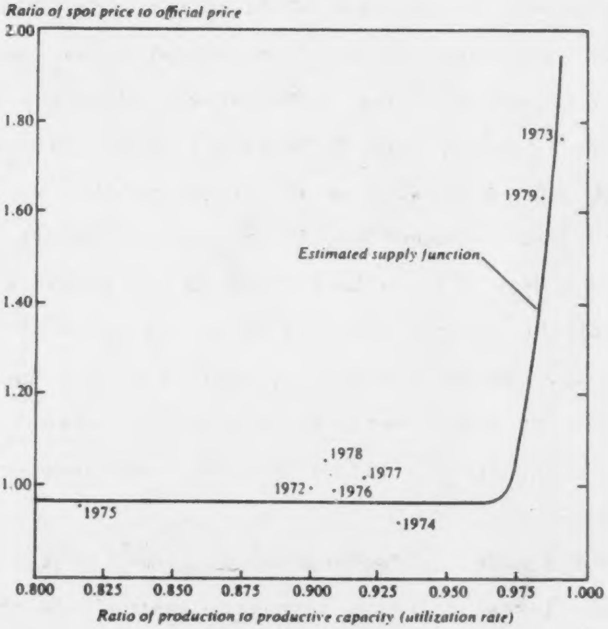
In fact, in DOE's model, domestic production never is able to meet domestic demand and, therefore, imports enter the market. However, those who export gas to the United States behave at least as silent partners in the oligopoly and do not try to steal more business by moving their prices down to undercut the abnormal profits of American producers. Indeed, they set their price at the theoretical marginal price -- the alternative fuel price. In DOE's analysis, this is $4.69/mcf (1980 $).

The marginal costs cited above generate a curve with a very shallow slope until conventional production is exhausted (on an annual basis) and a very steep slope thereafter. Interestingly, economist William Nordhaus has recently drawn a supply curve for the oil market with a similar shape (see Figure A.6). This curve is not unlike the curve DOE uses in its conceptual discussion (see Figure A.7). However, note that the slope of the actual curve derived from DOE's data is much more inelastic (steep) after the point of "inflection." Again, this difference in shape has two points of significance which will be elaborated below. First, it makes the potential benefits of oligopoly relatively secure. That is, the benefits are impervious to (or robust with respect to) the assumptions made about the shape of the demand curve. Second, it has important implications for market behavior even under the assumption of competition. It means that the market will not be very responsive to price changes.

DOE's model is "solved" at $4.69/mcf -- the equivalent of the lowest priced alternative (net of transmission and distribution costs). The market settles at a point at which about 16 percent of the maximum potential demand is not captured by gas producers. That is, 16 percent of the potential demand is allowed to slip away to alternative fuels.

FIGURE A.6

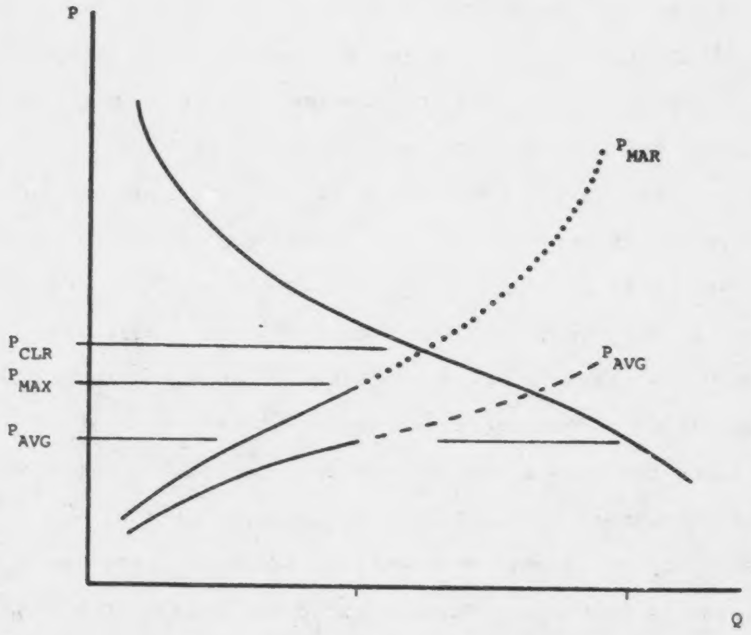
AN ESTIMATED SUPPLY FUNCTION FOR CRUDE OIL



Source: William Nordhaus, "Oil and Economic Performance in Industrial Countries," Brookings Papers on Economic Activity, 2, 1980, p. 369.

FIGURE A.7

THE DEPARTMENT OF ENERGY'S
CONCEPTUAL SUPPLY CURVE



Source: DOE, Two Market Analysis, p. A.99

3. The Market at Equilibrium

As noted above, the shapes of the supply and demand curves have important implications for the behavior of the natural gas market, even under assumptions of competition. Because the curves are so steep, i.e., inelastic, the market will not be very responsive to price changes. Neither demand nor supply will be changed much, even in the face of relatively large price increases. This insensitivity to price changes, even under the assumptions of competition, deserves further empirical analysis.

Even in DOE's analysis, in the long run, the supply elasticity is very small. Every decontrol scenario leads to a lower total supply than a continuation of NGPA. Furthermore, in the short run, DOE's analysis shows very small supply responses to price increases. Table A.4 shows the calculation of the aggregate market elasticity that DOE projects for accelerated phased decontrol, when compared to a continuation of NGPA. It can be seen that the price elasticity of supply is less than .07 in all years and the average is only .04. That is extremely small. DOE's data is intended to test comparisons between scenarios within years (e.g., NGPA compared to accelerated decontrol in 1983). However, the conclusion about supply elasticity stands up when the data is looked at in another way. For example, note that the supply elasticity between the year before decontrol and the year after decontrol under NGPA (compare 1984 to 1985) is only .039 percent.

Table A.4

IMPLICIT SUPPLY ELASTICITIES
IN THE AGGREGATE NATURAL GAS MARKET

	NGPA Base Case			Accelerated/Phased Decontrol (All New Scenario)			
	(1) Wellhead Price (1980$/mcf)	(2) Domestic Demand (BCF)	(3) Wellhead Price (1980$/mcf)	(4) Domestic Demand (BCF)	(5) % Price Difference (5)=[(3)-(1)]/(1)	(6) % Demand Difference (6)=[(2)-(4)]/(4)	(7) Implicit Elasticity (7)=(6)/(5)
1982	2.27	17737.6	3.05	18033.9	34.3	.5	.015
1983	2.42	17155.0	3.81	17605.0	57.4	2.6	.045
1984	2.61	16671.7	4.42	17440.5	69.4	4.6	.066
1985	4.45	17131.6	4.69	17088.7	-		

Source: DOE, Two Market Analysis, Attachment IV.

Calculation of the demand elasticity is more complex since there is a great deal of fuel switching that goes on in the gas market. Industrial users of oil switch to gas as do some residential consumers. Table A.5 presents a calculation of the implicit demand elasticities in the aggregate gas market that DOE projects for accelerated decontrol. In order to take account of fuel switching, the demand utilized as the basis for the calculations is the maximum potential gas demand, i.e., the total energy consumed by all potential gas users. Since the oil price is identical for all scenarios, any change in demand must be due to changes in the natural gas price and changes in the mix of oil and gas used by the aggregate of consumers. That is, if some oil consumers switch to gas, they may pay a price that is lower than they would have paid for oil. Their effective price is lower and their demand will be higher. The aggregate price paid by all consumers would also be lower. To compensate for this shift in the mix of fuels, we have calculated an "effective" average energy price for all potential gas consumers under NGPA and used it as the basis for calculating demand elasticities.

It will be noted that demand elasticities are somewhat higher than the supply elasticities, ranging from .088 to .184 and averaging about .14. The implicit elasticity for the year in which decontrol begins under NGPA is .18. These elasticities are consistent with other estimates.[3] They are also quite low compared to other commodities.

Table A.5

IMPLICIT DEMAND ELASTICITIES IN THE AGGREGATE NATURAL GAS MARKET

	NGPA Base Case			Accelerated/Phased Decontrol (All New Scenario)		Estimating the Elasticity		
	(1) Wellhead Price (1980$/mcf)	(2) Effective Wellhead Price	(3) Domestic Demand (BCF)	(4) Wellhead Price (1980$/mcf)	(5) Domestic Demand (BCF)	(6) % Price Difference (6)=(4)-(2)/(2)x100]	(7) % Demand Difference [(7)=(3)-(5)/(2)x100]	(8) Implicit Elasticity (8=7/6)
1982	2.27	2.44	22908.7	3.05	22495.1	25.0	-2.2	-.088
1983	2.42	2.54	22659.1	3.81	20754.1	50.0	-9.2	-.184
1984	2.61	2.72	2268.6	4.42	20461.6	62.5	-9.3	-.149
1985	4.45	4.02	20438.0	4.69	—	-	-	-

Source: DOE, Two Market Analysis, Attachment IV.

Thus, the shapes of the supply and demand curves do not resemble the classical, moderately elastic straight lines typically used to depict "competitive" situations. Any theoretical conclusions drawn about typical competitive situations on the basis of those typical curves should not be extrapolated to the natural gas market. Above all, one must not assume a great deal of price sensitivity even where competition is assumed. The implications of these steeply sloping supply and demand curves (when compared to the classical curves of competitive supply and demand), which are explored in other reports in this series, are:

1. Total supply under decontrol is not greater than under a continuation of NGPA, even though prices are higher, because supply responses are small.
2. The equity loses that one might predict for decontrol are larger than expected because demand responses are small and consumers bear more of the burden than expected.
3. The efficiency gains that one might predict for decontrol are smaller than expected because supply and demand responses are smaller than expected.

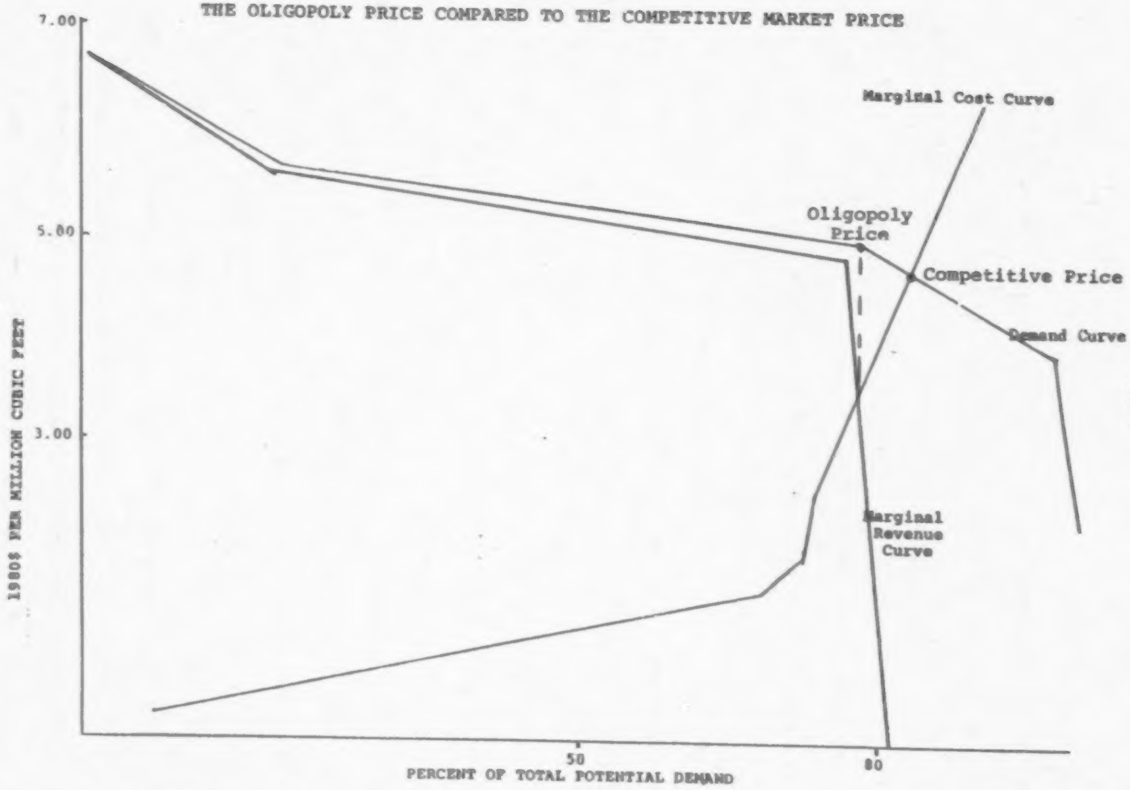
Having examined the implications of the shape of the supply and demand curves for the analysis when competitive behavior is assumed, we turn next to the analysis of situations in which non-competitive behaviors are assumed.

E. The Oligopoly Solution

If producers behave rationally, they will examine their marginal cost and marginal revenue curves in order to choose the price/quantity combination which will maximize profits. If they are oligopolists or monopolists, each

FIGURE A.8

THE OLIGOPOLY PRICE COMPARED TO THE COMPETITIVE MARKET PRICE



Source: Table A.1 and A.2.

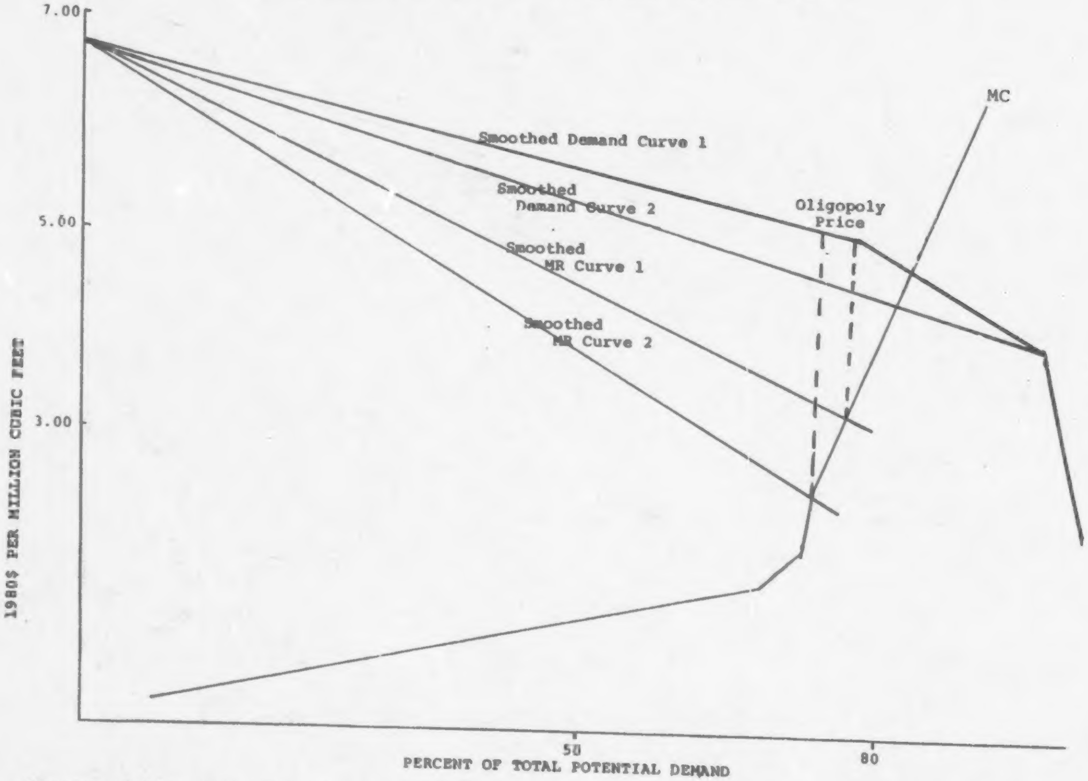
producer will not face a perfectly elastic demand curve. In fact, each oligopolist will face a demand curve that has a slope some place between the market demand curve and a perfectly flat demand curve. For purposes of this analysis, we will assume that each producer faces a demand curve with the slope of the market demand curve. This would fit a strict monopoly or a number of oligopoly arrangements.

In order to arrive at the monopoly (oligopoly) price, we must calculate the marginal revenue curve (see Figure A.8). Because the actual data is not smooth, the marginal revenue calculations are somewhat erratic, but an actual plot of the curve shows that the point where marginal costs equal marginal revenues is around the $5.00 point. Several smooth curves yield almost identical results (see Figure A.9).

Because both the marginal cost and marginal revenue curves are so steep, this point of market equilibrium under oligopoly behavior is quite robust. That is, if we were to assume that the shape of one of the curves was different, or we were to shift either curve up or down, the result would be largely unaffected. For example, Figure A.10 shows the analysis with the marginal cost curve calculated assuming marginal costs escalated at 15 percent (real) per year (but holding import prices constant). The oligopoly price would be altered little, ranging from $5.00 to $5.10, depending on which specification of the marginal revenue curve is used. If import prices escalate at 15 percent per year, the results still are about the same.

FIGURE A.9

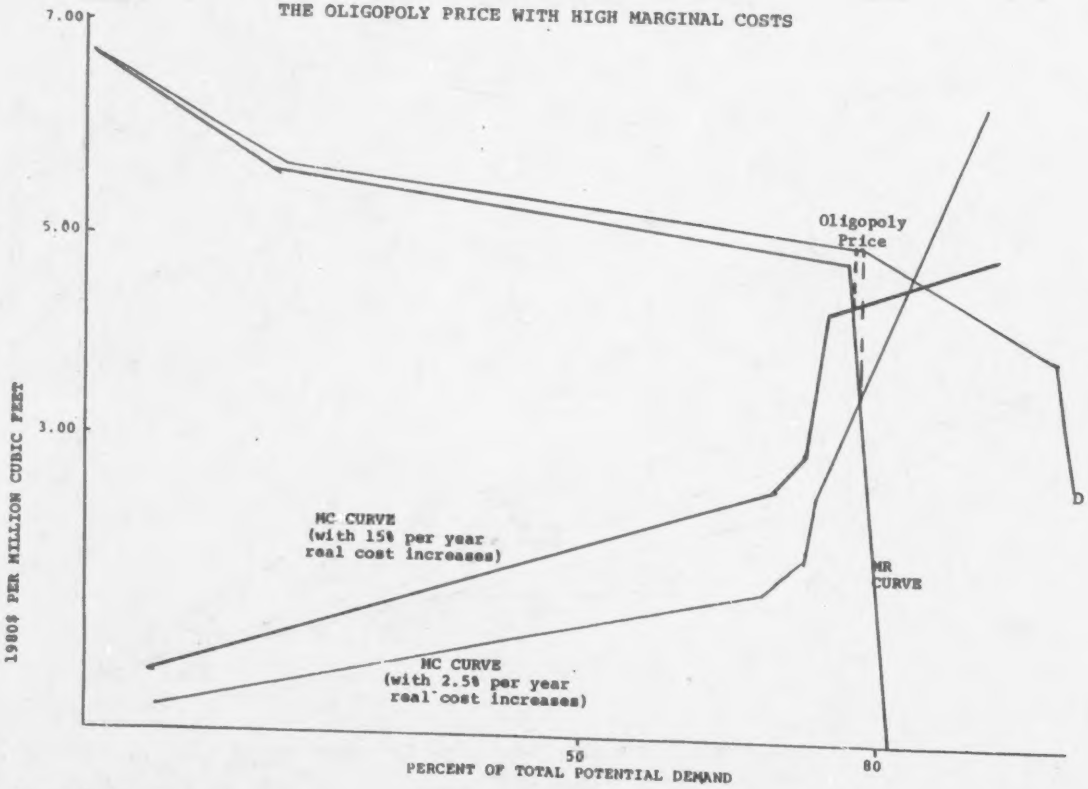
THE OLIGOPOLY PRICE WITH SMOOTHED DEMAND CURVES



Source: Tables A.1 and A.2

FIGURE A.10

THE OLIGOPOLY PRICE WITH HIGH MARGINAL COSTS



Source: See text

It should be noted that the oligopoly price would reduce supply by about 6 percentage points below the competitive market solution. Assuming a higher cost curve, the reduction in supply might be as large as 13 additional percentage points. Thus, an oligopoly assumption will lead to a market price about 10 percent higher than the competitive assumption with the quantity supplied reduced by at least 6 percentage points.

A message of equal significance to be drawn from the analysis is that the oligopoly price will be sensitive to the residential, not the industrial, market. That is, over one-quarter of all the demand occurs as interstate residential demand at $5.08 and this appears to be the critical point on the demand curve.[4] The high sulfur residual oil market is not important to the oligopolist and he foregoes most of it.

The residential demand is the most important point on the demand curve and it is a point about which there are significant differences of opinion in regard to the true elasticity of demand. In the next section, we examine an alternative assumption about residential and commercial demand. This leads us to redraw the demand curve and examine the implications of a differently shaped demand curve for the market price set by oligopolistic behavior.

F. Alternative Assumptions About Residential/ Commercial Sector Demand

In calculating the alternative fuel prices for industrial and electric utility demand, DOE included fuel conversion costs (i.e., the cost of switching to gas) where such costs are assumed to exist. Moreover, at the margin, dual fuel burning capacity was assumed to exist so that there are no conversion costs. DOE did not factor conversion costs into the alternative fuel price for the residential and commercial markets since these markets were not near the theoretical margin.

However, if residential and commercial demand is going to play a critical role in setting the oligopoly price, then the rational oligopolist would definitely want to take conversion costs in those sectors into account. That is, if residential and commercial consumers must incur additional costs to convert from natural gas to some alternative, this raises the effective cost of the alternative fuel. Oligopolists can capture some of this in their price without fear of losing that demand. In fact, there is very little dual fuel burning capacity in the residential and commercial sectors and very significant conversion costs in those sectors.

Let us take a simple example. First, we assume conversion costs of $1400 to be amortized (simple payback) over seven years.[5] Spread over an average annual consumption of 100 million BTUs per year, this would add $2.00/mcf to the effective alternative fuel price.[6] The commercial sector would have larger volumes of gas consumed but higher conversion costs, so that $2.00/mcf is a reasonable estimate for this sector as well. Finally, we assume that all residential and commercial users must incur these costs.

The resulting demand curve (see Figure A.11) becomes much smoother than the earlier curve and less elastic, i.e., steeper. A straight line marginal revenue curve now cuts the marginal cost curve at a lower quantity leading to a higher price. The oligopolist would optimize profits in the $5.40/MCF range and supply would be reduced by an additional 10 percentage points.

This modification of the demand curve leads to rather robust results. If we assume only $1.00/mcf in conversion costs, the oligopoly price would be between $5.30 and $5.40.

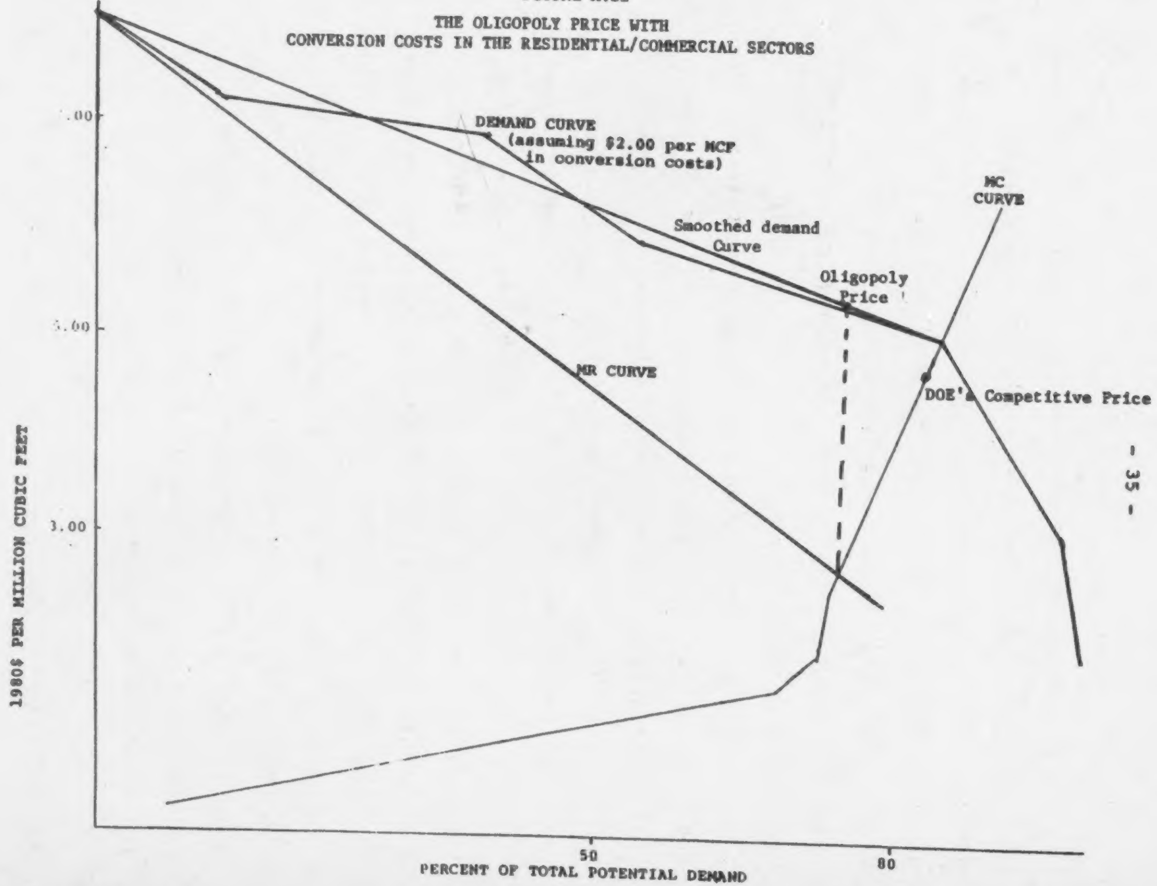
Obviously, different assumptions about conversion costs and/or more detailed analysis of the capacity to switch fuels in the short and long term might alter these outcomes. However, some conversion costs must be factored in and a price range of $5.30-$5.40 for the oligopoly wellhead price seems to be a good estimate. This is a price that is about 15 percent higher than DOE's assumed market clearing price and about twice as high as the industry estimates. The quantity supplied would be about 15 percent below the competitive market solution which means that 30 percent of the total demand is foregone.

G. Summary and Conclusion

In this Appendix, the possible impact of oligopolistic, as opposed to competitive, behavior on the market price of natural gas has been examined.

FIGURE A.11

THE OLIGOPOLY PRICE WITH
CONVERSION COSTS IN THE RESIDENTIAL/COMMERCIAL SECTORS



Source: See text

It has been shown that the configuration of the supply and demand curves is such that oligopolists could administer prices with considerable security. In contrast to the market clearing price estimated by DOE of $4.69/mcf, an oligopoly situation could result in a market price in excess of $5.40, although a range of $5.30 to $5.40 may be more likely.

The estimation of the supply curve also reveals that the rate of return on natural gas production is extremely high -- between 100 and 300 percent. These rates of profit can be presumed to reflect an absence of competitive conditions on the supply side of the market.

From a more general perspective, the shape of the demand and supply curves that have been calculated should caution against simplistic analyses of the gas market even where competition is assumed. Both curves are quite steep (i.e., inelastic) at the point of equilibrium, meaning that they are insensitive to price changes.

FOOTNOTES

[1] DOE, Two Market Analysis of Natural Gas Decontrol (Washington, DC: Government Printing Office, November 1981).

[2] A brief description of the basic structural characteristics of the natural gas market that lead us to this conclusion can be found in Dr. Mark Cooper, Director of Research, Consumer Energy Council of America, "The Implementation of Title I of the Natural Gas Policy Act of 1978," testimony before the Committee on Energy and Natural Resources, United States Senate (November 5, 1981).

[3] Robert S. Pindyck, The Structure of World Energy Demand (Cambridge, MIT Press, 1979).

[4] The slope of the demand curve can be described as follows:

There is a section of the curve (about 20 percent of the total demand) that is relatively inelastic (steep) at high wellhead prices (between $5.70 and $6.70/MCF in 1980 $). This demand occurs in the intrastate market. This block combines high priced alternative fuels with low transmission costs. That is, the wellhead gas price could be quite high because the alternative is expensive and transmission and distribution costs are low.

There is then a second section of the curve (about 60 percent of total demand) that appears quite elastic (between $5.00 and $5.60/MCF in 1980 $). Most of this block (43 percentage points of the 60 percentage points) is made up of the interstate residential, commercial and industrial nonboiler demand. This block combines high priced alternatives with high transmission costs.

Next, there is a block (about 18 percent of total demand) which is relatively inelastic at prices between $3.90 and $5.00/MCF in 1980 $. This is primarily industrial demand -- plus some commercial demand. This includes the category of high sulfur residual.

Finally, there is a small block of demand (about 3 percent) that is very inelastic at low prices. This block is intrastate boiler demand.

In DOE's analysis, the industrial demand between $39.0 and $5.00 is the critical marginal demand. In the oligopoly situation, the residential demand above $5.00 appears to be the critical marginal demand.

[5] See, Consumer Energy Council of America, "An Analysis of the Economics of Fuel Switching Versus Conservation for the Residential Heating Oil Consumer" (Washington, DC, October 5, 1980) for a discussion of conservation costs.

The CHAIRMAN. Mr. Greenberg.

STATEMENT OF DAVID I. GREENBERG, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. GREENBERG. Mr. Chairman. Members of the committee. Consumer Federation is pleased to be here today.

Perhaps no other legislative issue matters more to the pocketbooks of the 35 million consumers who make up CFA's 200 consumer, labor, senior citizen, cooperative, and small farmer organizations.

They have watched their natural gas bills rise 418 percent over the last 9 years. They have endured decisionmaking by FERC that served solely the interests of gas producers; and they have been shocked by the appearance and impact of "take-or-pay" contracts whose irrationality and unfairness is apparent to the most casual observers.

Now, as a remedy, they are asked to accept the decontrol of old natural gas prices, an action that will force them to turn over between $40 and $70 billion to the 20 largest gas producers.

Strip to its essentials—that is what this package is about, and that is its enduring feature.

Under current law, controls on new gas will expire in 1985 in any case. Other issues addressed by the package, for example, "take-or-pay" contracts and automatic passthroughs can be dealt with simply and straightforwardly on their own, given a genuine desire to do so.

So, it is CFA's belief that the other serious problems in natural gas pricing can be resolved and will be long forgotten; at the same time the disastrous consequences of decontrolling old gas continue to reverberate throughout the economy.

In order to understand the ramifications of old gas decontrol, last year CFA energy consultant, Ann Lower, assisted by Agnes Tabah, undertook a 5-month study of old gas, titled "The Powerful Twenty and Old Gas."

CFA selected for study natural gas contracts between the top 20 domestic producers of gas and the top 15 interstate pipeline purchasers.

These 20 purchasers supply 72.3 percent of the old gas sold by the pipelines, which accounts for 60 percent of the old natural gas sold interstate; and 20 percent of all gas sold in this country.

Using purchase gas adjustment forms filed with FERC, the CFA research team retrieved data, producer by producer, and contract by contract.

What they found is quite alarming. Simply stated, the decontrol of old gas will benefit the large gas producers—Mobil, Exxon, Texaco, Gulf, Shell, Standard Oil, Tenneco tremendously. The figures bear mentioning.

In the 7-year period from 1983 to 1990, the top 20 producers stood to gain $68.3 billion from immediate decontrol of old gas, and $56.9 billion from phased decontrol.

Even under phased decontrol, individual energy firms would have realized the following huge gains: Gulf, $5.7 billion; Mobil,

$5.2 billion; Texaco, $5 billion; Exxon, $4.8 billion; Shell, $4.2 billion.

The total decontrol profits would go up to $7 billion per firm, and much of this windfall would come from the 55 percent of old gas contracted for prior to 1972, gas that in most cases cost literally pennies to produce at present.

Given the current recession and the related drop in world oil prices, it is possible that the President's package would furnish additional profits for these firms of only about $40 billion, but it is equally likely that a stronger economy in 1986, the year all controls would expire, would make the CFA numbers look conservative, for if our experience energy decontrol has taught us anything, it is that we should be modest about our ability to predict its impact on the economy.

In 1979, Secretary of Energy Schlesinger estimated that oil decontrol would cost consumers $16 billion between July 1981 and September 1981.

Later the administration was forced to raise its estimate to almost $50 billion.

Similarly, a 0.3-percent rise in inflation attributable to oil decontrol was off, only by a factor of 13. The actual impact, according to a congressional study, was closer to 4 percent.

Thus, the CFA estimates, which are based on producers and pipelines, constituting less than 65 percent of the old gas market may undershoot the eventual impact on the consumers and the economy.

We believe the massive costs of decontrolling old gas overpower any possible benefits.

Of course, proponents of decontrol ask us to believe that competition will prevent the scenario we have drawn. We cannot accept that proposition, whereas my copanelists, especially Dr. Cooper, have just pointed out the facts in the natural gas market simply are not characteristic of a market where competition will serve to hold prices down.

The President's package contains another answer, however: To the extent that competition fails to hold prices down, FERC will.

The history and overriding philosophy of FERC would make this argument funny, were it not so sad. Again, the statements of my colleagues on this panel, illustrate the inaction and action by FERC.

Let me just make one comment. Our study of old gas suggests that FERC may even have trouble with the basic pricing categories. We found 18 separate cases where pipelines charged rates for pre-1973 contract gas, anywhere from $1.37 to $2.07 per Mcf, at a time when the legal maximum for 1973 gas was $1.04.

The CFA followup analysis of these old gas prices reveals that over 20 percent of pre-1973 contract gas is being sold at an average price of $1.98 per Mcf—90 cents above the ceiling for 1973 gas.

When House Energy and Commerce Committee Chairman, John Dingle, inquired about these figures, FERC responded that this old gas was eligible for the higher price.

CFA currently has the matter under study, and we will provide the committee with the results when it is completed. Even if FERC openly has a legal explanation for this pricing disparity, the fact remains that the commission has given producers every benefit of the doubt, and has taken every opportunity to grant them higher prices at the expense of consumers and the economy.

We simply cannot believe that FERC can turn a complete about-face.

But even if it could, we must reiterate our basic position: The bargain struck in this package is unacceptable. Consumers, industry, and the economy as a whole, cannot bear the decontrol of old gas. It will produce not 1 MCF of gas; it will not provide $1 to entrepreneurial gas drillers; it will only succeed in taking billions away from those who need it most, and giving billions to those who need it least.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Greenberg follows:]

Statement of

DAVID I. GREENBERG, LEGISLATIVE DIRECTOR

On Behalf of

CONSUMER FEDERATION OF AMERICA

Mr. Chairman and members of the Committee. Consumer Federation of America (CFA) is pleased to have the opportunity to appear before you today to discuss the President's natural gas decontrol package.

Perhaps no other legislative issue matters more dearly to the pocketbooks of the 35 million consumers who make up the membership of CFA's 200 consumer, labor, senior citizen, cooperative and small farmer organizations. They have watched their natural gas bills rise an astounding 418% over the last 9 years. They have endured decisionmaking by the Federal Energy Regulatory Commission (FERC) that served solely the interest of gas producers and cost them billions of dollars. They have been shocked by the appearance and impact of take-or-pay contracts, whose irrationality and unfairness is apparent to the most casual observer.

Now, as a remedy, they are asked to accept the decontrol of old natural gas prices, an action that will force them to turn over between $40 and $70 billion to the 20 largest gas producers and billions more to the rest of the gas industry. Stripped to its essentials, that is what this package is about, and that is its enduring feature. For, under current law, controls on new gas will expire in 1985 in any case. Other issues addressed by the package, for example, take-or-pay contracts and automatic pass-throughs, can be dealt with simply and straightforwardly on their own given a genuine desire to do so. It is CFA's belief that the other serious problems in natural gas pricing can be resolved and will be long forgotten at the same time that the disastrous consequences of decontrolling old gas continue to reverberate through the economy.

In order to understand the ramifications of old gas decontrol, last year CFA Energy Consultant Ann Lower, assisted by Agnes Tabah, undertook a five-month study of old gas, titled "The Powerful Twenty and Old Gas." CFA selected for study natural gas contracts between the top 20 domestic producers of natural gas and the top 15 interstate pipeline purchasers (See Table 1). The 20 producers supply 72.3% of the old gas sold by these pipelines, which accounts for 60% of the old natural gas sold interstate and 20% of all gas sold in this country (See Table 2). Using Purchase Gas Adjustment forms filed with FERC, the CFA research team retrieved data producer by producer and contract by contract, the first time such data has been pulled together coherently.

What Lower and Tabah found is quite alarming. Simply stated, the decontrol of old gas will benefit the large gas producers--Mobil, Exxon, Texaco, Gulf, Shell, Standard Oil, Tenneco--tremendously. The figures bear mention. In the seven-year period from 1983-90, the top twenty producers stood to gain $68.3 billion from immediate decontrol and $56.9 billion from phased decontrol (See Table 3). Under the former scenario--which targeted decontrolled natural gas prices to a world oil price of $33/barrel--individual energy firms would realize the following huge gains: Gulf, $5.7 billion; Mobil, $5.2 billion; Texaco, $5 billion; Exxon, $4.8 billion; Shell, $4.2 billion. Much of this windfall would come from the 55% of old gas contracted for prior to 1972--gas that in most cases costs literally pennies to produce at present.

Given the current recession and the related drop in world oil prices, it is possible that the President's package would produce additional profits of only $40 billion to the major oil and gas companies. But it is equally likely that a stronger economy in 1986--the year all controls would expire--would make the CFA numbers look conservative. For, if our experience with energy decontrol has taught us anything, it is that we should be modest about our ability to predict its impact on the economy. In 1979, Secretary of Energy James Schlesinger estimated that oil decontrol would cost consumers $16 billion between June of that year and September 1981. Later, the Administration was forced to raise its estimate to almost $50 billion. Similarly, the prediction of a .3% rise in inflation attributable to oil decontrol was off by a factor of 13: the actual impact, according to a Congressional study, was closer to 4%. Thus, the CFA estimates--which are based on producers and pipelines constituting less than 65% of the old gas market--may undershoot the eventual effect on consumers and the economy.

While our study explores the question of who wins from decontrolling old gas, it is important to delineate the full consequences to the losers as well. First, and most obviously, residential users of natural gas will pay a heavy price. Using an overall price tag of $48 billion, the Citizen/Labor Energy Coalition (CLEC) has estimated that the decontrol of old gas would cost the average gas-heating household more than $1,000 over three years in cities heavily dependent on old gas. That is a very scary figure in a time of economic hardship.

The second loser is the economy itself. Money flowing into oil companies is money that cannot be spent on rebuilding the economy. Consumers cannot buy goods and services and businesses cannot invest in new productive assets and research and development when their energy bills skyrocket. Thus, old gas decontrol would exacerbate the problem pointed out by Bankers Trust Company in 1981, when the costs of oil decontrol forced the nonenergy business sector to underinvest by $50 billion. The reason for that underinvestment is clear. From 1978 to 1980, according to a study by the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee, the oil and gas industry accounted for 98% of the increase in profits for the entire Fortune 500. There is no reason to expect a different result after the decontrol of old natural gas.

The loss in consumer and business purchasing power translates quite directly into a loss of jobs. Using a gas decontrol cost of $86 billion--which for the entire market is consistent with CFA's $56-$68 billion figures--

Employment Research Associates calculated that the rise in energy costs would strip the economy of approximately 3 million jobs, with the largest losses coming in the retail, services, transportation, metal and textile industries.

The macro impact of decontrolling old gas reaches beyond heating costs, jobs and investment to interest rates and the credit markets. The major beneficiaries of decontrolled old gas prices are many of the same companies that took their oil decontrol profits and helped fuel the recent merger/acquisition binge. CLEC estimates, for example, that the sixteen largest oil companies increased their spending on acquisitions by 600% in the three years following oil decontrol, from $2.3 billion to $16 billion. Such spending--normally financed by long-term lines of credit--crowds out investment by less creditworthy borrowers and puts upward pressure on interest rates. The industries most likely to be denied loans if old gas decontrol contributes to another merger spree are the basic industries damaged most by increased gas prices--steel, auto, heavy manufacturing and farming. Companies in these sectors receive a double jolt: higher gas prices cut profits available for investment and force firms to borrow; higher interest rates restrict their borrowing and cut into profits still further.

A final important point is the regional burden of decontrolling old gas. The impact of sharply increased gas prices will be felt disproportionately in certain parts of the country. More than 60% of the gas sold interstate goes to 15 northern and midwestern states. This is the part of the country already reeling most from the recession. Especially hard hit will be cities like Boston, Providence, Hartford, Philadelphia, Pittsburgh, Chicago, Milwaukee, Indianapolis and Memphis. In an effort to understand exactly whose gas customers would bear the brunt of old gas decontrol, the CFA study has estimated the costs of decontrol pipeline by pipeline in Table 4.

Taken together, these massive costs overpower any possible benefits which might accrue from enacting the Reagan decontrol package. Of course, proponents of decontrol ask us to believe that competition will prevent the scenario we have drawn. We cannot accept that proposition. For, as the Consumer Energy Council of America (CECA) pointed out in testimony to the Committee last year:

1. Two-thirds of the natural gas market is captive, a monopoly situation;

2. Twenty large producers of natural gas control over half the gas market and over two-thirds of the oil market, an oligopoly situation;

3. The close affiliation between producers and distributors in the natural gas market eliminates arms-length transactions and creates anti-competitive behavior; and

4. Thirty percent of the contracts for old gas contain indefinite escalator clauses, a percentage sufficient to force the decontrolled price of old gas up to its oil price equivalent. The very existence of such clauses demonstrates the tremendous market power that producers wield over distributors.

The above facts are simply not characteristic of a market where competition will serve to hold prices down after controls are lifted.

The package before the committee today contains another answer, however. To the extent that competition fails to hold prices down, FERC will.

The recent history and overriding philosophy of FERC would make this argument funny, were it not so sad. The same FERC that has made it too easy for producers to classify their wells into the highest-priced category, the same FERC that has allowed prices within those categories to rise to extremely high levels, and the same FERC that has interpreted NGPA to allow prices for old gas to increase at unjustified rates now, it seems, will be transformed into the consumer's champion. The wolf, it appears, will shed its outer skin to reveal a lamb underneath. We simply doubt it.

In fact, our study of old gas suggests that FERC may even have trouble with the basic pricing categories of natural gas. Ann Lower found 18 separate cases where pipelines charged rates for pre-1973 contract gas anywhere from $1.37 to $2.07 per mcf at a time when the legal maximum for pre-1973 gas was $1.04 per mcf (See Table 5). A CFA followup analysis of these old gas prices revealed that over 20% of pre-1973 contract gas is being sold at an average price of $1.98 per mcf, 90¢ above the ceiling for pre-1973 gas. When House Energy and Commerce Committee Chairman John Dingell inquired about these figures, FERC responded that this old gas was eligible for the higher prices. CFA currently has the matter under study and will provide the Committee with the results when it is completed. But even if FERC ultimately has a legal explanation for this pricing disparity, the fact remains that the Commission has given producers every benefit of the doubt and has taken every opportunity to grant them higher prices at the expense of consumers and the economy. CFA does not believe that FERC can turn a complete about-face.

But even if it could, we must reiterate our basic position: the bargain struck in this package is unacceptable. Consumers, industry and the economy as a whole cannot bear the decontrol of old gas. It will not produce one mcf of gas. It will not provide one dollar to entrepreneurial gas drillers. It will only succeed in taking billions away from those who need it most and giving billions to those who need it least.

CFA thanks the Committee for the opportunity to testify.

TABLE 1[a]

PRODUCER CONTRACTS WITH 15 INTERSTATE PIPELINES, OLD GAS BY CONTRACT VINTAGE, EARLY 1982[b]

Producer Name	Total Old Gas Contracts[c]			Contract Vintage 1972 and Before		Contract Vintage 1973 and After		Contract Vintage Not Reported
	Volume in BCFs	Total Cost in Millions	Average Rate Dollars per MCF	Percent of Total Old Gas Contract Volume	Average Rate Dollars per MCF	Percent of Total Old Gas Contract Volume	Average Rate Dollars per MCF	Percent of Total Old Gas Contract Volume
Mobil	383.1	532.5	1.39	39.0	.70	45.5	1.95	15.5
Exxon	365.4	514.4	1.41	63.5	1.04	33.8	2.07	2.7
Texaco	355.3	427.4	1.20	41.6	.82	53.8	1.48	4.6
Gulf	332.6	193.9	.58	85.3	.42	6.2	2.37	8.4
Shell	319.7	451.1	1.41	40.4	.92	48.3	1.76	11.3
Tenneco	303.4	521.0	1.72	65.1	1.54	34.6	2.05	.2
Std. of Indiana	274.2	327.3	1.19	67.4	.96	20.7	1.86	11.9
Std. of California	240.5	344.4	1.43	38.7	1.04	56.4	1.70	4.9
Phillips	195.6	175.9	.90	63.8	.74	22.5	1.43	13.7
Atlantic Richfield	175.1	175.7	1.00	59.3	.93	20.5	1.18	20.2
Getty	169.2	216.3	1.28	54.9	1.02	23.9	1.73	21.2
Cities Service	166.7	159.6	.96	74.5	.74	11.5	1.58	14.0
Union	143.5	191.3	1.33	34.2	1.09	41.0	1.70	24.8
Superior	138.2	177.6	1.29	22.2	.89	18.4	1.47	59.4
Sun	125.3	176.6	1.41	36.1	.93	51.1	1.75	12.7
El Paso	123.2	155.8	1.26	92.1	1.23	6.1	1.70	1.7
Conoco	101.3	123.9	1.22	62.4	.96	23.3	1.89	14.2
Pennzoil	70.0	109.2	1.56	27.4	1.05	72.5	1.75	.1
Marathon	56.2	90.2	1.60	32.4	.87	60.6	1.96	7.0
Columbia	40.3	71.2	1.77	28.5	1.07	39.0	1.32	32.6
Total	4,078.8	5,135.3	1.26	54.3	.92	33.8	1.78	11.9

[a] Reprinted from The Powerful Twenty and Old Gas, by Ann K. Lower and Agnes Tabah, Consumer Federation of America, 1982.

[b] The data on the top 20 producer contract sales of old gas to pipeline purchasers summarized in Table 1 were compiled from the pipelines' Purchased Gas Adjustment (PGA) filings with the Federal Energy Regulatory Commission. Pipeline companies that file with the Commission report the volume and cost of their expected purchases by producer company and by contract date. Thus, the filing of producer contract sales by pipelines to support their rate adjustment request provides an otherwise unobtainable store of information to the public for establishing a data base on producers. For a full discussion of the development of producer data, see Appendix A of Ibid, beginning on page 25.

[c] Gas covered by NGPA Sections 104 and 106.

TABLE 2[a]

TOTAL OLD GAS PURCHASED BY 15 INTERSTATE PIPELINES FROM TOP 20 PRODUCERS, AND ALL OTHERS, EARLY 1982[b]

	Total Old Gas Purchased[c]		Old Gas Purchased from Top 20 Producers			Old Gas Purchased from Other Producers		
Pipeline Name	Volume in BCFs	Average Rate Dollars per MCF	Volume in BCFs	Percent of Total Old Gas Purchased	Average Rate Dollars per MCF	Volume in BCFs	Percent of Total Old Gas Purchased	Average Rate Dollars per MCF
Tennessee	751.0	1.44	663.9	80.4	1.44	87.2	11.6	1.47
Natural Gas Pipeline of America	623.7	1.44	483.6	77.5	1.48	140.1	22.5	1.29
El Paso	583.0	1.16	459.9	78.9	1.07	123.1	21.1	1.49
Northern	496.3	.87	281.6	56.7	.86	214.8	43.3	.89
Michigan/ Wisconsin	389.5	1.36	269.5	69.2	1.27	120.0	30.8	1.55
Texas Eastern	368.2	.80	305.5	83.0	.62	62.6	17.0	1.67
Transco	357.2	1.49	198.7	55.6	1.41	158.5	44.4	1.58
Trunkline	356.5	1.79	301.3	84.5	1.75	55.2	15.5	2.03
Panhandle Eastern	326.4	.94	115.6	35.4	1.03	210.8	64.6	.89
United	309.9	1.47	233.7	75.4	1.43	76.2	24.6	1.59
Texas Gas Transmission	303.1	1.26	241.2	79.6	1.32	61.9	20.4	1.03
Columbia	265.0	1.62	194.8	73.5	1.65	70.2	26.5	1.52
Southern	223.9	1.25	169.5	75.7	1.12	54.3	24.3	1.65
Cities Service	160.8	.62	109.0	67.8	.60	51.7	32.2	.67
Colorado Interstate Gas (CIG)	127.4	.96	51.1	40.1	.75	76.3	59.9	1.10
Total	5,641.9	1.27	4,078.9	72.3	1.26	1,562.9	27.7	1.30

[a] Reprinted from The Powerful Twenty and Old Gas, by Ann K. Lower and Agnes Tabah, Consumer Federation of America, 1982.

[b] The data on the contract sales of old gas to pipeline purchasers by the top 20 producers, and all others, summarized in Table 1 were compiled from the pipelines' Purchased Gas Adjustment (PGA) filings with the Federal Energy Regulatory Commission. For a full discussion of the development of producer data, see Appendix A of Ibid beginning on page 25.

[c] Gas covered by NGPA Sections 104 and 106.

Table 3[a]

ESTIMATED COST INCREASE TO CONSUMERS OF 15 PIPELINE COMPANY PURCHASES OF OLD GAS' UNDER PHASED-IN AND TOTAL DECONTROL AS COMPARED TO THE NATURAL GAS POLICY ACT BY PRODUCER,[b] 1983 - 1990

	Natural Gas Policy Act, 1983 - 1990			Phased-In Decontrol, 1983 - 1990			Total Decontrol,[c] 1983 - 1990		
Producer Name	Estimated Total Purchases (MMBTU)	Estimated Average Rate ($ per MMBTU)	Estimated Total Cost (Billions)	Estimated Average Rate ($ per MMBTU)	Estimated Total Cost (Billions)	Estimated Increase in Total Cost (Billions)	Estimated Average Rate ($ per MMBTU)	Estimated Total Cost (Billions)	Estimated Increase in Total Cost (Billions)
Mobil	1,836.6	1.66	3.0	4.44	8.2	5.2	4.99	9.2	6.2
Exxon	1,751.4	1.69	3.0	4.44	7.8	4.8	4.99	8.8	5.8
Texaco	1,705.0	1.44	2.5	4.41	7.5	5.0	4.99	8.5	6.0
Gulf	1,593.8	0.70	1.1	4.30	6.8	5.7	4.99	8.0	6.9
Shell	1,531.5	1.70	2.6	4.42	6.8	4.2	4.99	7.6	5.0
Tenneco	1,454.0	2.07	3.1	4.50	6.5	3.4	4.99	7.3	4.2
Std. of Indiana	1,326.1	1.42	1.9	4.40	5.8	3.9	4.99	6.6	4.7
Std. of California	1,152.6	1.72	2.0	4.45	5.1	3.1	4.99	5.8	3.8
Phillips	935.8	1.09	1.0	4.35	4.1	3.1	4.99	4.7	3.7
Atlantic Richfield	838.6	1.20	1.0	4.37	3.7	2.7	4.99	4.2	3.2
Getty	810.9	1.54	1.2	4.42	3.6	2.4	4.99	4.0	2.8
Cities Service	798.6	1.14	0.9	4.36	3.5	2.6	4.99	4.0	3.1
Union	686.8	1.62	1.1	4.43	3.0	1.9	4.99	3.4	2.3
Superior	662.3	1.54	1.0	4.42	2.9	1.9	4.99	3.3	2.3
Sun	601.0	1.68	1.0	4.45	2.7	1.7	4.99	3.0	2.0
El Paso	592.2	1.59	0.9	4.42	2.6	1.7	4.99	3.0	2.1
Conoco	484.9	1.45	0.7	4.41	2.1	1.4	4.99	2.4	1.7
Pennzoil	336.1	1.87	0.6	4.47	1.5	0.9	4.99	1.7	1.1
Marathon	270.2	1.93	0.5	4.48	1.2	0.7	4.99	1.3	0.8
Columbia	193.7	2.09	0.4	4.51	0.9	0.5	4.99	1.0	0.6
Total	19,562.1	1.51	29.5	4.42	86.4	56.9	4.99	97.8	68.3

[a] Reprinted from The Powerful Twenty and Old Gas, by Ann K. Lower and Agnes Tabah, Consumer Federation of America, 1982.

[b] Table 3 is an estimate of the increase in the cost of old gas, by the top 20 producers, to interstate consumers for the period 1983-1990 under two separate decontrol scenarios. The base case shown in the table assumes a continuation of the NGPA, with monthly prices escalating at rates of inflation assumed by the Reagan Administration in its fiscal 1983 budget. The first comparative case is the case of decontrol, phased-in during 1983-1984. The second comparative scenario is the case of total decontrol, beginning in 1983. The method for estimating prices for the two decontrol scenarios is that which was published as one possible methodology in the Federal Energy Regulatory Commission's Notice of Inquiry on the "Impact of the NGPA on Current and Projected Natural Gas Markets," Docket No. RM82-26, issued on April 28, 1982. The producer data base from which the estimates were made was developed by the Consumer Federation of America from pipelines' Purchased Gas Adjustment (PGA) filings with the Federal Energy Regulatory Commission and published in The Top 20 Natural Gas Producers and Their Sales of Old Gas to 15 Interstate Pipelines, by Ann K. Lower and Agnes Tabah, Consumer Federation of America, 1982. For a full discussion of the methodology used in the estimates, see Ibid, beginning on page 25.

[illegible] SALES OF OLD GAS UNDER PHASED-IN
AND TOTAL DECONTROL AS COMPARED TO THE NATURAL GAS POLICY, BY PIPELINE,
1983 - 1990

Pipeline Name	Natural Gas Policy Act, 1983 - 1990			Phased-In Decontrol,^{b} 1983 - 1990			Total Decontrol^b 1983 - 1990		
	Estimated Total Purchases (MMBTU)	Estimated Average Rate ($ per MMBTU)	Estimated Total Cost (Billions)	Estimated Average Rate ($ per MMBTU)	Estimated Total Cost (Billions)	Estimated Increase in Total Cost (Billions)	Estimated Average Rate ($ per MMBTU)	Estimated Total Cost (Billions)	Estimated Increase in Total Cost (Billions)
Tennessee	3181.4	1.77	5.6	4.47	14.3	8.7	4.99	15.9	10.3
G P of A	2317.7	1.81	4.2	4.57	10.5	6.3	4.99	11.6	7.4
l Paso	2204.1	1.33	2.9	4.45	9.8	6.9	4.99	11.0	8.1
orthern	1349.1	1.06	1.4	4.54	5.9	4.5	4.99	6.7	5.3
ich/Wisc	1291.3	1.56	2.0	4.31	5.6	3.6	4.99	6.4	4.4
x Eastern	1463.7	.75	1.1	4.20	6.3	5.2	4.99	7.3	6.2
ransco	952.2	1.94	1.7	4.20	4.2	2.5	4.99	4.8	3.1
runkline	1444.2	2.15	3.1	4.71	6.6	3.5	4.99	7.2	4.1
anhandle E.	553.9	1.27	.7	4.17	2.5	1.8	4.99	2.8	2.1
nited	1120.1	1.76	1.9	4.64	5.1	3.2	4.99	5.6	3.7
exas Gas	1156.5	1.62	1.9	4.25	5.1	3.2	4.99	5.8	3.9
olumbia	933.6	2.02	1.9	4.67	4.2	2.3	4.99	4.6	2.7
outhern	812.9	1.37	1.1	4.50	3.6	2.5	4.99	4.0	2.9
ities S.	522.9	.78	.4	4.60	2.3	1.9	4.99	2.7	2.3
IG	244.8	.91	.2	4.29	1.0	.8	4.99	1.2	1.0
otal^c	19,548.4	1.52	30.2	4.44	87.0	56.9	4.99	97.6	67.5

Gas covered by NGPA Sections 104 and 106.

The estimated total purchases under the Natural Gas Policy Act scenario are assumed to be the same for the phased-in and total decontrol scenarios.

Totals may not add up precisely to the totals published in Table 3 due to rounding and slightly modified formulas used in the calculations.

TABLE 5[a]

SELECTED CONTRACT RELATIONSHIPS BETWEEN PRODUCERS AND PIPELINES, OLD GAS BY PRE-1973 CONTRACT VINTAGE, EARLY 1982

Company Contract Relationship		Total Old Gas Contracts[b]		Pre-1973 Contracts	
Producer	Pipeline	Volume (Mcf)	Average Cost (Dollars per MMBTU)	Percent of Total Old Gas Contract Volume	Average Cost (Dollars per MMBTU)
Mobil	Southern	12,348,261	1.85	33.3	1.84
Exxon	El Paso	9,644,748	1.31	79.3	1.19
Exxon	Trunkline	102,184,536	1.53	83.4	1.37
Exxon	Texas Eastern	9,823,214	1.58	99.0	1.59
Shell	Tennessee	30,378,466	1.46	74.3	1.32
Shell	Trunkline	35,408,949	1.86	36.2	1.34
Tenneco	Tennessee	258,707,118	1.68	66.1	1.50
Tenneco	NGP of A	14,941,325	2.06	99.0	2.07
Tenneco	United	4,177,564	1.32	35.0	1.20
Std. of Ind.	Trunkline	14,765,876	1.95	73.0	2.01
Std. of Ind.	Panhandle E.	14,217,731	1.90	97.4	1.91
Std. of Calif.	Trunkline	17,999,701	1.75	69.6	1.58
Phillips	Columbia	2,213,636	1.10	43.3	1.38
Getty	TX Gas Trans.	10,657,004	1.37	97.5	1.39
Union	Tennessee	5,901,332	1.84	52.1	1.58
Union	Trunkline	6,842,945	1.93	96.0	1.82
Union	Texas Eastern	14,209,878	1.95	63.9	1.83
Superior	El Paso	3,005,592	1.33	92.4	1.30
Superior	TX Gas Trans.	317,250	1.27	49.3	1.69
El Paso	El Paso	122,461,860	1.23	92.7	1.20
Conoco	El Paso	8,600,424	1.24	86.1	1.21
Marathon	United	7,233,748	1.73	26.2	1.81
Columbia	NGP of A	108,965	1.87	100.0	1.87

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[a] Reprinted from The Powerful Twenty and Old Gas, by Ann K. Lower and Agnes Tabah, Consumer Federation of America, 1982.

[b] Gas covered by NGPA Sections 104 and 106.

The CHAIRMAN. Thank you, all of you. We are already seeing some market substitution in the industrial market of gas prices move up; is that not correct?

[No response.]

The CHAIRMAN [continuing]. I don't think there is any argument on that question.

And that substitution of one energy source for another energy source is the result of market forces, I think that would be correct, too. I don't believe that there would be any argument on that point. As oil prices drop and gas prices rise, people move away from natural gas and start using alternative fuel.

I gather from your statements that you believe that the opportunity for the industrial market to shift is not a sufficient competitive force in the natural gas market to affect behavior.

Is that a correct summary?

Mr. BRANDON. Mr. Chairman, I think evidence would show that in markets where this shift is taking place most dramatically, the price for gas delivered at the city gate still remains high, and, in fact, is increasing.

So, you have a situation where industrial customers can leave the system quickly and of course commercial and residential customers cannot, without some significant upfront costs for converting, and second of course, those people who are left on the system then are required to pay for the higher rates resulting from less people sharing the fixed costs of the distribution.

The CHAIRMAN. Well, I have heard some comments from some gas producers that they have gas which they cannot sell today that they would be happy to sell today, if they could, at lower prices.

Have you heard any such comment?

Mr. BRANDON. We have been in touch with a number of such producers, and you are absolutely right, I think it points to the fact that smaller independent producers are willing to sell their gas below the ceiling price today, happy with the fact that they could still make a handsome profit on that.

But they don't have access to the markets because pipelines refused to deliver that gas because they are locked into high take-or-pay contract obligations, primarily with the larger producers.

The CHAIRMAN. If, as a matter of fact, legislation were passed which provided some abrogation of take-or-pay contracts, and permitted the substitution in the industrial market of other supplies, thus reducing the volumes flowing through the pipelines; and contained a provision that required that the pipelines transport gas to market where they had sufficient capacity to do so, unused capacity to do so, would that spread the market competitive forces to such a point that it might begin to affect citygate prices?

Mr. BRANDON. I think there are two weaknesses in that argument. The first is that I think by developing the spot market in the natural gas industry you are going to see a competition for those supplies by industrial customers, many of whom are less price-sensitive—ones that need natural gas for feed stock and processing.

And you might see a perverse situation where the spot market actually gets bid up for natural gas in that circumstance.

And I believe the other thing that it is clear in the situation where you have got a decontrolled atmosphere as would be provided for in the President's bill that there is no incentive to push down the price, but, in fact, those larger producers are going to push up the price.

The CHAIRMAN. Well, isn't there an incentive, if there is a surplus of supply?

Mr. BRANDON. Well, not if the producers can maximize their profits by selling less volumes at a higher cost, which I think is exactly the situation today.

If that were not the case, you would find producers wanting to drop their price when most of them are sticking to the ceiling prices under the law and any of the renegotiation that is going on with the large producers is not effectively driving prices down.

The CHAIRMAN. Well, isn't that exactly what OPEC is arguing about right now, on the international oil market?

Mr. BRANDON. Of course, the difference there is that we all have greater opportunity, I think, to go across the street and try a different gas station and try to drive the price down. We don't have that same opportunity with the natural gas industry.

The CHAIRMAN. Well, that was the question that I asked earlier with respect to pipeline capacity. If as a matter of fact they begin losing market, the pipeline capacity is greater than the existing or remaining market, then you do begin to get competition among the producers who wish to sell to the remaining available market; is that correct?

Mr. BRANDON. Well, again, I would argue that as long as there are producers who have the greatest influence over the pipelines in maximized profits in keeping prices up even though volume is down, they will pursue that course.

Dr. COOPER. I think the OPEC analogy is interesting because here you have a group of 13 or so producers with relatively different endowments, producing at 40 percent of capacity, in defense of a price that is 10 times the marginal cost of production, which is just an amazing feat, and they have held that for a year or so and they are under pressures and so forth. I don't see the situation in the gas industry that bad.

But it is not entirely clear to me that the gas market clears in the No. 6 market, which is what we are talking about, and I have submitted a document which looks at that; and this morning we heard the reference to the No. 2 market.

In point of fact, give them the opportunity to exercise whatever bargaining power they have, producers could well in fact prefer to clear in the No. 2 market as opposed to the No. 6 market; and that gives us a much higher price than the assumption that people work with that every producer is willing to clear in the No. 6 market.

Now, there are a lot of producers who are willing to clear in the No. 6 market, and I think we have seen some of that, but it is not entirely clear that the great bulk of the industry is very much interested in chasing after No. 6 customers.

The CHAIRMAN. Well, as a matter of fact, Congress made the assumption that at the time NGPA was passed the clearing would be in a No. 2 market, and it never anticipated that there would be any clearing at No. 6.

That has proven to be at least a partially faulty assumption.

Dr. **Cooper**. Obviously, in drafting NGPA, in that whole process, there were faulty assumptions that worked their way in.

The **Chairman**. Thank you.

Senator Ford.

Senator **Ford**. I ask three general questions of the panel.

Do any of you support any of the bills pending before the Committee on Energy and Natural Resources?

Mr. **Brandon**. Well, Senator Ford, I would say in our statement we outline elements of the bill that we think would make sense.

I heard this morning a number of the Senators who appeared before you outlined legislation that they are working on or intending to introduce; and I would say that that is close to what we would be supporting.

There are elements of a number of bills that we would support, but we feel a comprehensive solution is the only answer.

The biggest tragedy, I think, would be if the Congress acted again on the natural gas pricing issue, and dealt with, for example, just the take-or-pay question, not recognizing that the ceiling prices and the steady march upward that they provide are as much a part of the problem as the high take-or-pay.

Senator **Ford**. Can I make this kind of a statement—that basically those Senators—Danforth, Eagleton, and Kassebaum that were here this morning—their bill tends to be closer to your position than the present bills or the administration's bill that is before the committee?

Mr. **Marlowe**. Senator, that certainly would be correct from the standpoint of the AFL-CIO. Our executive council just last month adopted a statement of principles which is incorporated by reference in my testimony, and there is no bill presently introduced which fully meets those principles and their comprehensive nature.

But, as a bill which Senator Kassebaum and Senators Danforth and Eagleton talked about this morning comes the closest to meeting those principles.

Senator **Ford**. Dr. Cooper.

Dr. **Cooper**. Let me make one point.

Senator **Ford**. Don't be too long. We only have 10 minutes and I have a few questions I want to ask.

Dr. **Cooper**. Last night I was sitting and looking over the Heinz bill and the bill that is merging in the House and the one that Senator Kassebaum referred to, and the administration bill, and I count about 24 different provisions, stipulations, which is why, in fact, the Natural Gas Policy Act and the rewrite, if there is one, is so complex and difficult; and one can go down the list and find sort of agreements that take-or-pays have to be set back, for instance, and then differences of opinion about how you set take-or-pays—do you pick a number or do you do a study and figure out is this what take-or-pays are supposed to do, and if it is, then, do we want a permanent number or do we want a rolling number, depending on market?

Of those 24 divisions, you can find, I think, if you start from the Heinz bill and move toward the Kassebaum bill, you eliminate sort of 17 or 18 of them, in which there is substantial agreement, and then there will be differences in philosophy and level.

But it is a complex question. You can't simply say, pick any one provision and say, for instance, well, if we have market outs and contract carriers, that solves the problem, because there are three pieces to the industry and different sectors in each piece, and each of them has a different problem.

And, so, it needs careful—careful tuning as the people who went through NGPA are likely to remember.

Senator **Ford**. Mr. Greenberg, do you want to add anything to what has been said?

Mr. **Greenberg**. Just that the CFA supports the package that is developing in the House. What I heard this morning sounds like the three Senators will have substantially the same sort of bill here.

Senator **Ford**. Would this panel provide me and the committee with specific statutory language for any amendment that you would like to see adopted if the committee were to use S.615 as the markup vehicle for natural gas legislation?

Mr. **Marlowe**. Certainly.

Mr. **Brandon**. We would be happy to do it.

Senator **Ford**. Now, let me ask you this question: If the amendments you support are not adopted, and you had to vote up or down on S.615, would you support it or would you support a continuation of the existing law?

[No response.]

Senator **Ford**. You know, that may be the final question.

Mr. **Brandon**. Senator Ford, our analysis is that the President's bill will increase prices at a greater rate than would occur under the Natural Gas Policy Act, although in both cases the increases are substantial, and we believe unacceptable and certainly for the people we represent.

Senator **Ford**. I understand that, but if that is your option, though, would you want the President's bill or stay——

Mr. **Brandon**. We would not like—we would fight against the President's bill; I hope the Senate in its wisdom comes up with a much better solution than the suggestions that you just made.

Senator **Ford**. If we have 20/24ths, sort of like we have 20-20 hindsight, you are going to get a "doozy."

[Laughter.]

Dr. **Cooper**. In support of that position let me make the following argument: If those market forces are out there, they will work on those contract provisions. And there is no need to rip away NGPA and sort of as the last protection. So, if the choice is to test market forces then—and you say I can't improve on the market forces—then let's test them with some protections left, not without them.

I've been saying that for 16 months. I've been waiting for someone to come in and say, "See, the contract has been rewritten and the market works." And they haven't been rewritten in at least the 16 months since I last testified. So the NGPA is preferable.

Senator **Ford**. Mr. Greenberg.

Mr. **Greenberg**. We would not support 615.

Senator **Ford**. All right, as representatives of consumers, can you tell me how many consumers have been or soon will be cut off of natural gas services because they cannot pay their bills? Anyone have a pretty——

Mr. **Brandon**. Senator Ford, we—actually, I submitted that in a study of this committee last December on that very issue. We, in surveying the public service commissions and utility companies around the country we projected about 300,000 people shut off this winter. I think that the individual statistics that are emerging would indicate that that figure might have been low.

I know in the State of Ohio alone there were 60,000 families that were shut off before that State enacted an emergency on shutoffs.

Senator **Ford**. Let me go down the panel very quickly, Mr. Chairman.

Mr. Marlowe, in calling for a price rollback for natural gas, do you have any concern that the outcome in the long run would be a gas shortage such as those experienced in 1976-77 which put many of our workers out of jobs? If Congress were to roll back the prices on natural gas, at what price would you start worrying about workers losing their jobs because of shortages and the consequent—the curtailments?

Mr. **Marlowe**. Senator, I don't have any concern that a price rollback, the kind that is being considered in the legislation which was discussed this morning by the various Senators is going to be significant enough to in any way hurt the natural gas industry. It will provide some measure of relief.

I think if I had my way we would roll back to levels that were 3, 4 years ago. But I think in all the reality, talking about rolling back to a level of a year ago, which is perhaps somewhere in the neighborhood of a 5 percent, no more than 10-percent rollback of ceilings, is not going to cause serious disruption to the gas industry, certainly not going to hurt workers. In fact, I think it's going to help workers.

When industries are able to buy gas at betters prices they are going to be able to expand, and that is going to provide more jobs.

Senator **Ford**. Mr. Brandon, you gave the 300,000 figure. Let me ask you this question that popped in my mind: Should we establish a policy for natural gas pricing for all 200-plus million Americans based on what 300,000 Americans can afford? Or would it be better to establish a policy that is optimum for 200 million people and provide supplemental assistance through the low-income heating assistance program, low-income weatherization and programs for that 300,000?

Mr. **Brandon**. I think, Senator, the problem is not just with the 300,000 people, it's the millions of people who are unemployed today and millions more who are working but find that natural gas prices are becoming a larger and larger share of their family budgets, cutting back on the other necessities that they need and cutting back on any kind of discretionary income that could, in fact, help move the economy along at a time when it needs it most.

If I could add for a second on the question you asked Mr. Marlowe, I have an analysis here by Solomon Bros. on oil stocks dated October 15, 1982. And their projection of the cost of projection on oil—and I think you can make a comparable argument using a Btu equivalency for gas—would indicate that the cost of production for the gas after tax would be approximately $1.56 on an average. The price ceiling rollback that is referred to in some of the legislation that's been discussed would roll prices back to no more than about $3 on an average.

So you've got more than twice the price that is considered the cost of production on average.

Senator **Ford**. Dr. Cooper, on page 8 of your statement you say that fundamental flaws in the market "structural and institutional imperfections" have created the problems, not NGPA. However, your seven parts of the solution do not appear to change any structural and institutional aspects of the gas industry. Do you intend to solve the structural and institutional imperfections with your solution?

Dr. **Cooper**. Well, it intends to perfect the regulation of an imperfect industry. And it's consistent with the essential points that have been raised earlier in terms of contract clauses, bidding practices, just and reasonable prudent standards of conduct and so forth. But it intends to perfect the regulation, not the industry.

Senator **Ford**. Mr. Chairman, my time is up. And I have some additional questions for Mr. Greenberg and others, which happens to all of us. I have an amendment to be up on the floor shortly and been called and have to go. And we'll have a vote, I understand, on the avenue of compromise, too. And would it be in order, Mr. Chairman, that I be given the opportunity to submit questions to panels one, two, and three today and have some sort of a deadline on when that could be in to us?

The **Chairman**. Yes; we will do that. And assuming that the questions are not excessively voluminous, as I would expect they are not.

Senator **Ford**. Mine are not.

The **Chairman**. We could ask the panelists to have those answers back to us in not more than a week. A week to 10 days. If you could do that I think they would be included in the record.

Senator **Ford**. I thank the Chairman, he's always so courteous and it's nice to work with him.

The **Chairman**. Thank you.

Senator **Ford**. And I thank you, sirs.

The **Chairman**. Senator Murkowski.

Senator **Murkowski**. Thank you, Mr. Chairman. I think we all agree in observing the comments that have been made on this legislation, what has been stated, written, that there seems to be little agreement. The producers don't agree, transmission companies don't agree, the consumer groups don't agree. That, perhaps, gives me some degree of comfort on the other hand.

I think the committee has a long-range responsibility that you gentlemen would agree, and that is the long-term gas resources of this country. And there has been a great deal said today about the situation with regard to decontrol of oil and the political motivation behind that. I think you would agree that we indeed have a substantial change as a consequence of decontrol as far as our crude oil situation in this country is concerned.

One can't help but assume that there is a similarity and an application and a passthrough. And I would specifically request your comments on how this committee can, in a responsible manner, continue to support what we have seen in NGPA, and very little change in the status quo, and maintain the long-range responsibility to insure adequate incentives to get drilling rigs back in action. We've got 50 percent of them laid up at the present time. And if we don't do anything today are we not going to be forced or considered somewhat irresponsible if, in fact, in the not too distant future this country does not have an adequate supply of gas?

Mr. BRANDON. Senator Murkowski, I think one point that is very important to make clear, and that is that the President's bill, by decontrolling old gas actually creates a disincentive for exploration by providing—by no longer providing the kind of incentive high-cost prices that new gas achieves under the NGPA, compared to old gas. And what I think we'd find——

Senator MURKOWSKI. Then why do we have 50 percent of our rigs laid up now under the current act?

Mr. BRANDON. The reason that gas production is down is not because the NGPA doesn't provide enough incentives, it's because demand is essentially down because we're in the middle of a major recession.

I think the natural gas industry, anyone looking at it today would say there's a demand constraint, not a supply constraint. And that's why drilling rigs are down. You can't store natural gas the way you can oil, as you know. And we believe that there is plenty of incentive in the present ceiling prices. And as I indicated, there is in fact, the ceiling prices are in fact higher than they ought to be.

The example of that is that there are many independent producers who are willing to sell their gas for $2.75 and $3 an Mcf below the ceiling prices today, yet they don't have access to the pipelines and the markets that would allow them to do that.

Senator MURKOWSKI. What are the incentives though under rollback?

Mr. BRANDON. The rollback is only at the ceiling price.

Senator MURKOWSKI. I know, but what is the incentive?

Mr. BRANDON. The incentive is that the price is still going to be about $3 an Mcf for new gas, which as I mentioned earlier, is probably twice what the average cost is to produce that new gas. That's quite a large margin. And I think there are plenty of producers in this country that would tell you, small producers who would tell you that they can make a profit selling their gas for $3 an Mcf. We've been in contact with a number of them.

Senator MURKOWSKI. Anyone else care to comment on that? I'd like to specifically direct the application of what's happened under decontrol of oil, recognizing that we have a similar application in the sense that we have a nationwide network of interconnecting pipelines, and so the argument that you can go to one gas station but you can't necessarily do the same thing in the gas business, has certainly an application. But by the same token there is a parallel too.

I'd be interested in specific comments with regard to the application of what deregulation of oil has done to this country and why will it not logically follow that we'll have some of that fallout under what is not incidentally a bill to propose immediate deregulation but a phase down to 1986. I think that's often confused.

Dr. COOPER. The fundamental interpretation is whether deregulation has worked on the supply side or the demand side. In point of fact, in the industrial west we now have 35 million people out of work. Decontrol as we understand it started in June 1979, not January 1981 as the administration likes to remind us. By the time the administration decontrolled the battle was over. Oil prices had gone from about $16 a barrel in June—May 1979 to something approaching $36 a barrel on the date of the January termination of decontrol.

It's the demand side collapse——

Senator MURKOWSKI. Is it a market force?

Dr. COOPER. If you mean to solve the energy problem through depression, that's a market force. But that's not the way we look at the solution to the problem. It's not been an overwhelming supply-side response.

With respect to ceilings I think the logic behind rollback is the logic that has operated on old gas. There has been quote, unquote "rent dissipation." I would not like to see too much of it, but there's been a funneling of available economic resources on old gas that has been funneled into higher price gas. The logical rollback is the following: The ceilings have gotten too high, the revenues available are too large to continue to stimulate production. What you do is you rollback, you create the ability to move the rents around. You redirect incentives into new exploration.

For all the criticism of NGPA, the one thing that has worked in NGPA is the supply side response. It was a regulatory effort to stimulate. The rate of inflation has driven ceilings too high, you go back and you restimulate. That's the logic of rollback.

Senator MURKOWSKI. You use the comparison that decontrol occurs in a climate of recession, and you also use the same argument that the regulation under NGPA occurs in a climate of recession. It's driven the price up.

Dr. COOPER. I agree that the logic of the contract provisions has driven the price up, but I don't see that as a response to NGPA. I see that as a response to the distribution of bargaining power in the industry. It's a fundamental difference. It's not pipelines looking at NGPA and developing a strategy, it's pipelines looking at NGPA, yes, but also looking who they bargain with, and not being able to extract, reach the proper bargains to protect consumers and stimulate production.

Senator MURKOWSKI. Well, will old gas stay in the ground unproduced if it isn't decontrolled forcing consumers to take higher priced alternatives?

Dr. COOPER. If you remove the contract provisions one presumes that a certain of cheap, lower-priced gas will begin to move. With respect to gas that's shut in and not contracted, in a certain sense it's just an obligation to serve.

Producers have the power, they have the cash flow to sit on low-priced gas as long as they want.

Senator MURKOWSKI. So it would stay in the ground unproduced?

Dr. COOPER. It might stay in the ground until people became convinced that they had delivered it at a just and reasonable price.

Senator MURKOWSKI. How do you force that under this NGPA that we're under now? It doesn't work now. FERC can't make it work to the satisfaction of everybody, certainly.

Dr. Cooper. To the extent that you can remove the existing contract provisions that are keeping it in the ground you should free up a significant amount of gas. To the extent that there's gas in the ground now, producible, but producers are on strike, in essence, waiting for the price—which is I think a lot of what has happened—you probably can't, you cannot force it out of the ground other than seeing if you can capture whatever competitive pressures there are at the wellhead.

Senator Murkowski. It seems we have a dilemma here. How do we get it out of the ground if there isn't incentive to get it out of the ground, and how is the consumer better off if it stays in the ground? The consumer has to have the availability of it.

Now, I still get back to the point that we have seen decontrol of oil in the process, over a period of time, result in substantial reductions for the consumer. That's good. We've seen the control of gas all mixed up, recognizing that we've got a poor application under NGPA. The question is, What do we do about it? Neither one has worked satisfactorily, but it does appear that deregulation on oil has certainly had a beneficial effect on the consumer of the United States.

Mr. Brandon. Senator Murkowski, let me say that in that regard decontrol of oil has raised prices to consumers. When the decontrol process started in 1979, from that point to January 1981, when the President lifted off the remaining controls gas prices jumped 50 percent.

Senator Murkowski. But the market forces are at work now. And that's a proposal under this legislation. There is a phase-in period of several years before decontrol occurs.

Mr. Marlowe. I would say that there's a high level of unemployment and a very deep recession. If those are the market forces that are at work then I certainly don't like the effects of decontrol.

Senator Murkowski. Well, I don't either. But by the same token, we've seen the same market forces at work in the increase in the price of gas under the current regulations under NGPA. So we got a push. Where do we go from there?

Mr. Marlowe. I don't think that those current regulations require the high prices. I think that there are factors such as take-or-pay contracts in the other markets are non-free-market clauses which have done that.

The Chairman. Senator Nickles.

Senator Nickles. Thank you, Mr. Chairman. I apologize to our panelists for the fact that I was a little bit late, didn't catch all of your testimony, but I did catch, I think, some of the thrust of it.

All of you are totally opposed to any form whatsoever, to any form of decontrol of gas; is that a correct assumption?

Mr. Marlowe. That's correct.

Senator Nickles. Any other items that we should be controlling if we don't control natural gas? Should we expand that to fuel oil, or should we expand that to electricity, or should we expand that to wages? Or should we expand that? How far should we go in this endeavor to control resources?

Mr. Brandon. This is not an endeavor to control resources. It's an endeavor to keep controls on that have been in place for many, many years. And unless we want to restructure the gas industry and eliminate the monopoly that's given to distribution companies and pipelines, then I think we have to have these controls on. I'd be willing to talk about legislation, if you want, that eliminates the monopoly for distribution companies and pipelines and their service in terms of transporting and distributing natural gas.

But until you do that you're just not—you can't decontrol one end of the industry and expect anything to happen other than prices to go up as we've seen now. If there was a——

Senator **Nickles**. I don't think anyone was talking about decontrolling the commissions or the utility commissions that control it.

Mr. **Brandon**. That's exactly the problem, Senator. I think that unless you're talking about——

Senator **Nickles**. Do you want to decontrol those?

Mr. **Brandon**. No; I'm saying that as long as we have this system in place then you have to have controls at the producer end. You can't free up——

Senator **Nickles**. At the producer end. Any other item that should be controlled at the producer end?

Mr. **Brandon**. Well, we think that natural resources generally should be controlled unless they can respond to a free market. We don't believe they can. Certainly not in the natural gas industry.

Senator **Nickles**. Would that include coal? Fuel oil? I'm interested in any panelists, not necessarily Mr. Brandon. I'm just wondering, I was taking your philosophy and trying to analyze it. And it seems to me as if you want to control this market from beginning to end. It already has controls on the end. We're not talking about abolishing those controls. But we were at the beginning. And there's no other item that I can think of that is controlled by the Federal Government on the production end. Should we be?

I mean, if your philosophy is correct, it seems like we should be expanding our area of controls, that Congress has been remiss in missing coal or fuel oil or electricity, I don't know, nuclear power. How far should we go?

Mr. **Marlowe**. Senator, in many respects Congress——

Senator **Nickles**. Wages?

Mr. **Marlowe** [continuing]. Either at the Federal level or at the State level, many of the items that you mentioned are regulated if not actually controlled in a price sense, many are regulated. I think that the issue before this committee is the issue of natural gas and the impact that it is having—its prices are having on American consumers. And the fact that there is no way for the American consumer, be he or she an individual, a businessperson, a farmer, whatever, to signal their lack of appreciation for those high prices to the producers who have ultimate control. This is a fully monopolistic situation, non-free-market case, where the producer has too much power over everybody else down the line. That's why Congress has to treat it as a form of a public utility.

Senator **Nickles**. Let me ask you a question before I've got a kind of a time constraint and I'm going to have to move on. But kind of concluding in what Senator Murkowski was mentioning, was that unanimous amongst your group in opposition 2 years ago for the total decontrol of oil?

It was?

Mr. **Marlowe**. We certainly opposed it.

Senator NICKLES. In your studies that I've seen and various things about how detrimental this is going to be to the consumer and how it's going to affect in driving up the cost of living, CPI, et cetera, what did your studies show for the decontrol of oil 2 years ago?

Dr. COOPER. I welcome that question. In April 1979 the Consumer Energy Council said that the choice before the Congress was whether to plunge the country into the deepest recession since the Great Depression or to maintain controls on crude oil. And frankly, if you look at the last 3 years, an energy price induced recession, coupled with a contractionary response, which has been the response of every administration to rising energy prices, we have in fact seen an increase in unemployment of probably an average of four million workers. The Department of Energy study shows that we lost——

Senator NICKLES. Dr. Cooper, then the primary cause of the increase in unemployment is the increase in oil prices?

Dr. COOPER. I believe that for the decade of the 1970's a Department of Energy study estimated that something on the order of 40 percent of the increase in unemployment could be directly attributed to rising real energy prices.

Similarly, about 40 percent—and I have a study which examines that, and I will submit it to the committee for your—I believe I submitted it last year to the committee, but I will certainly submit it this year.

Senator NICKLES. I might just say, you know, you probably have a lot of studies, but the facts are that 2 years ago you were before this committee that basically said we don't want decontrol of oil. You said that if it did, it would cost consumers greatly, that the cost of gasoline would skyrocket, that the cost, the out-of-pocket costs would continue to increase when actually it's done just the exact opposite.

I don't think you have a very good basis—and here again, I've just been in the Senate for 2 years—that your past support or evidence is very credible.

Mr. BRANDON. Senator Nickles, can I correct that?

Dr. COOPER. The date of decontrol was June 1979 with oil at $16 a barrel. In January 1981 when the President finalized it, oil was already up almost to $20 a barrel. So if you want to talk about rising energy prices you have to start when decontrol started, not in January 1981, but in June 1979. And since that period a dozen econometric models—and that's the only analytic tool we have—have shown this tremendous impact.

Senator NICKLES. Let me ask another question.

Dr. COOPER. Yesterday the——

Senator NICKLES. OK, Mr. Cooper, let me ask you another question. Do all of you favor a rollback in the price of natural gas? All of you favor a rollback?

Mr. MARLOWE. In price ceilings, yes, sir.

Senator NICKLES. In the price ceilings.

Should we just—Let's say, you probably would agree with me it's kind of absurd to have 28 different categories of prices for gas. Do you agree with that? Or should we have 28 different prices? Yes? No? I don't—you don't know?

Dr. COOPER. The number of categories of natural gas is an effort to try and approximate a supply curve. That's all it is. You sort of figure out the cost of gas and the more categories you have the closer you can get to the supply curve.

Senator NICKLES. It doesn't make a whole lot of——

Dr. COOPER. As it turns out.

Senator NICKLES. It doesn't make a whole lot of sense.

OK, well, where should we, if we could roll back, where should we put the price? Should it be at $1 for all? Two dollars? Or 50 cents? Where are we going to put this price? I'm interested in where you think we should go.

We don't need to have all the price categories. Let's just say, according to your assumption, let's just say natural gas will not exceed, or let's go a little bit further and say gasoline will not be more than 50 cents a gallon. I don't know where, but that's the philosophy that you're trying to sell before this committee.

Can you give me a price that we should mandate? We don't need 28 prices. Let's just say natural gas shall not exceed $2 per Mcf and move in that direction.

Dr. COOPER. Most other commodities in a competitive market are transacted at their marginal costs plus a profit. In natural resource economics you encounter the problem of rent, where you have very low marginal cost gas and then higher, higher marginal cost.

Senator NICKLES. Where is the price? I'm looking for a price before my time runs out.

Dr. COOPER. If you wanted the best answer would be that each category of gas should be priced at its marginal cost plus a profit. That's the best answer.

Senator NICKLES. Can you give me, you've done so much work in this area and you're such an expert, can you give me what that price might be?

Dr. COOPER. It would vary for each category. One might go back to methodology 770 and 770(a) under the Natural Gas Act. One might——

Senator NICKLES. You don't know?

Dr. COOPER. We have not advocated that. What we have talked about is setting up an institutional framework that will—at least that's what I've talked about—that will elicit the delivery of supply at a price that bears a relationship, direct relationship to its cost of production.

Senator NICKLES. You don't have the price. Excuse me, do you have the price? Anybody have the price?

Just roll it back somewhere? We don't—somewhere back here——

Mr. MARLOWE. No; we've talked, certainly, about rolling back prices to a level of approximately January of 1982.

Senator NICKLES. Somewhere.

Mr. MARLOWE. Price ceilings.

Mr. BRANDON. It's a very specific price ceiling that's set under that proposal. It is much higher, unfortunately, than the cost of—marginal cost of production plus a reasonable rate of return. We're being overly generous.

If you want, we could recalculate something that's more closely reflective of the cost of production. I don't think you would necessarily be happy with those numbers. They'd probably be lower than we're advocating today.

Senator NICKLES. So but you'd pick out some figure—you could say 2 years ago or a year ago—and that would be the figure. Now, all of you, I noticed that several of your groups were highly labor supportive, or organized labor was supportive of your coalitions or something. I would think that would mean that they are interested in jobs. When you reach that point—and I've reached mine. That may be for your benefit and for mine.

I'll pass. Thank you, Mr. Chairnan.

Mr. MARLOWE. I would enjoy hearing the rest of that question, Senator, and responding to it whenever you like.

Senator NICKLES. I may give you that question in writing. You can respond to it.

Mr. MARLOWE. Be pleased to answer it. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Hecht.

Senator HECHT. Mr. Chairman, our time is so valuable today, I'd like to pass for the moment and hear these other panels and then reserve, as Senator Metzenbaum, my right to submit questions later.

The CHAIRMAN. OK, thank you, Senator.

I have just one question I would like to ask. CLEC submitted, and it has been made a part of the record, a study that shows the gas prices out of control, and the cost of inaction. And I think that study is the basis of a lot of the testimony that we're getting, not only from you but from others, and a lot of the comments we're getting from you and others.

What assumption does that study make with respect to the price of crude oil and petroleum products?

Mr. BRANDON. The study assumes that prices are at $30 a barrel for 4 years, which means a real decline in prices. That is a couple of dollars below what the President's proposal and studies are based on. We decided to be a little more conservative than the President about where oil prices are going to go.

And it also assumes, as the administration does, that the market clearing price for gas would be at 70 percent of the crude oil price.

The CHAIRMAN. At what percent?

Mr. BRANDON. Seventy percent.

The CHAIRMAN. And did you specifically analyze the administration's bill as the basis of this study?

Mr. BRANDON. This is based on an accelerated program of decontrol that is very similar to the administration's bill.

The CHAIRMAN. It is not based just on decontrol?

Mr. BRANDON. It is based on the accelerated decontrol proposals in the administration's plan and the—over the 4-year period.

The CHAIRMAN. Does it include the provisions that are in the administration's bill with respect to the passthrough review, the revision of the take-or-pay contracts?

Mr. BRANDON. It doesn't precisely include those. Although I would say that most of those provisions we feel will have minimal impact on the prices.

The CHAIRMAN. And the price cap?

Mr. BRANDON. The same. I think that our feeling is that the price cap will have minimum impact because it will be negotiated somewhere near the new price level.

I might add, also add, that this study is in line with a number of other studies. It's not the only one that's being used to project where the President's—prices on the President's bill might go. There have been some Wall Street analysts who indicate a 40-percent increase in 2 years. The GAO talked about a 40- to 80-percent increase over a 4-year period. So I think we're—and a number of the distribution companies and pipelines that have done an analysis also indicate that the increases under the President's bill would be in the range of 60 to 70 percent over that 4 years.

The CHAIRMAN. Mr. Greenberg, on page 2 of your testimony you state, and I quote, "If our experience with energy decontrol has taught us anything it is that we should be modest about our ability to predict its impact on the economy." Has your experience with energy decontrol taught you to be modest about your ability to accurately predict natural gas prices if gas were decontrolled?

Mr. GREENBERG. Well, I think our experience has taught us that we usually shoot low.

The CHAIRMAN. That the impact is always greater?

Mr. GREENBERG. Has been.

The CHAIRMAN. And that——

Mr. GREENBERG. We tried to be conservative in our numbers. I'm sure that's true of CLEC's number's too.

The CHAIRMAN. You predicted that the administration bill would cost consumers about $40 billion.

Mr. GREENBERG. Well, what we—our study was done at a time when the world oil price was about $33 a barrel. And so that yielded some numbers, about $68 billion. But that was only for 65 percent of the market.

So if we went back and we calculated based on present oil prices and 100 percent of the market, I think we would probably still get numbers bigger than the $68 or $56 billion that are in our study.

The CHAIRMAN. Was that prediction based on current data such as current natural gas demand and supply and current oil prices?

Mr. GREENBERG. It was based on those current numbers starting or ending, I guess, in August. Or September, maybe.

The CHAIRMAN. Including current natural gas demand and supply?

Mr. GREENBERG. Well, what it assumed is that natural gas prices would, if old gas prices were decontrolled, they would rise to their crude oil equivalent.

The CHAIRMAN. It assumed that there is no market restraint on the—except the Btu equivalent of oil?

Mr. GREENBERG. I think that's right.

The CHAIRMAN. Thank you very much.

Senator MURKOWSKI. Mr. Chairman, may I just make a general comment?

The CHAIRMAN. Certainly, Senator Murkowski.

Senator MURKOWSKI. I want to express my concern—and it's not meant in support or criticism of the panel—but it represents a genuine concern that if we were to follow the contention and position of the panel to continue under NGPA regulations might lead this country to repeat the gas shortages we saw in 1979, which is surely not in the best interest of labor or the American consumer. And that is my concern, gentlemen.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

And thank you, gentlemen, very much.

We will next hear from a panel, the Chemical Manufacturers Association represented by Mr. James D. Beatty, the Council of Industrial Boiler Owners represented by Mr. Richard J. Bryan, the Petrochemical Energy Group represented by Mr. Patrick McNamara, and the Process Gas Consumers represented by Mr. Jack Elam.

Gentlemen, we have nine witnesses in two different panels to hear from yet today and to have the opportunity to ask questions of.

You each have submitted prepared statements. Those statements will each appear in the record in full. I will ask you to limit your remarks and their duration so that we can get to the questions and develop the record in the best possible way.

Mr. Beatty?

STATEMENT OF JAMES D. BEATTY, PROCTER & GAMBLE CO., ON BEHALF OF THE CHEMICAL MANUFACTURERS ASSOCIATION

Mr. BEATTY. Thank you, Mr. Chairman, Senators, staff. I am James D. Beatty, appearing today on behalf of the Chemical Manufacturers Association.

As the largest industrial consumer of gas, the chemical industry places paramount importance on an insured supply at the lowest reasonable cost. This is the goal of all consumers and it is not being satisfied by the NGPA.

The NGPA was intended to protect consumers, unify domestic gas markets, stimulate supply at reasonable cost and provide an orderly transition to a free market. The record clearly shows it has failed.

Consumer prices have increased by nearly 18 percent annually, as documented by a GAO study, every year for the past 9 years, demonstrating that price controls did not work prior to the NGPA under the NGA nor after enactment of the NGPA.

In fact, the pricing distortions of the NGPA have contributed unnecessarily to price increases that have occurred simultaneously with the declining demand for natural gas. This is a phenomenon that could only exist in an artificial market.

We support the basic concepts, compromises, and balances contained in S. 615. The chemical industry has long advocated smooth and orderly transition by a date certain of all natural gas wellhead ceiling prices to market clearing levels, the coordinated removal of both supply and demand constraints and free market access for all consumers, pipelines and distributors to all categories of gas, that would more nearly merge the interstate and intrastate markets into one.

All consumers of gas, residential as well as industrial, will benefit from restoring natural gas competition.

Competitive natural gas production means equitable pricing for all customers. Natural gas competition would lower energy costs.

Competition in the natural gas industry will improve our national economy.

Our specific comments are contained in our written submission. In the interest of time I would like to move through.

In summary, we represent a significant class of industrial gas consumers whose well-being and, in some cases, existence, is dependent upon adequate natural gas supplies at the lowest reasonable price.

We identify our needs and aspirations with all consumers including residential. We believe the consumers will best be served by total elimination of all price and nonprice constraints for the operation of the free gas market. Bills that would freeze or roll back natural gas prices are not in the consumers' interest as they will most certainly discourage low-cost production, continue unnecessarily high prices, and create future gas shortages.

When the NGPA was passed in 1978, few of us envisioned the distortions that would ravage natural gas consumers just 5 years later.

Consumer prices continue to climb at an alarming rate in spite of a declining market volume.

Expensive deep gas and tight sands production is encouraged while low-cost gas is shut in.

Canada, Mexico, and Algeria are rewarded for exporting high-cost gas to this country while associated gas is flared.

Now is the ideal time for Congress to restore the advantages of competition to natural gas for the benefit of all consumers. There is a current surplus of natural gas, world crude oil prices are declining, and natural gas prices have reached the interfuel market clearing level of No. 6 fuel oil in most areas of the country.

S. 615 provides an excellent starting point for collective legislation. We must not fear the free market. Supply and demand problems too complex for any of us to predict, let alone attempt to manage or manipulate, are readily solved by it. Only 2 years ago the opponents of deregulation were making dire predictions of the consequence of deregulating the price of oil in this country. Yet, by every objective measure, that action has been most successful in spite of massive interference by the OPEC cartel.

Thank you for the opportunity of appearing today.

[The prepared statement of Mr. Beatty follows:]

STATEMENT OF THE
CHEMICAL MANUFACTURERS ASSOCIATION
PRESENTED BY JAMES D. BEATTY
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
CONCERNING NATURAL GAS POLICY

MARCH 10, 1983

Mr. Chairman, Members of the Committee, and Staff, I am James D. Beatty, of the Procter & Gamble Co., appearing today on behalf of the Chemical Manufacturers Association (CMA). CMA is a nonprofit trade association whose company members represent more than 90% of the productive capacity of basic industrial chemicals within this country.

The chemical industry is the largest industrial consumer of natural gas. We account for over 10% of the United States' total natural gas use. Over half of this consumption, or approximately one trillion cubic feet per year, is for essentially nonsubstitutable feedstock and process uses.

As a major industrial consumer, the chemical industry places paramount importance on an insured supply of natural gas at the lowest reasonable costs. This is the goal of all consumers and it is not being satisfied by the Natural Gas Policy Act (NGPA).

The multitude of natural gas categories and price ceilings created by the NGPA were intended to protect consumers, unify domestic gas markets, stimulate supply, provide an orderly transition to a free market and ultimately balance supply and demand. The record shows that it has failed.

Consumer prices have increased by approximately 20% every year for the past nine years, clearly demonstrating that pricing provisions have not worked. They have not protected consumers. In fact, we are convinced that the pricing distortions of the NGPA have contributed to unnecessary price increases that have occurred simultaneously with the declining demand for natural gas. This is a phenomenon that could only exist in an artificially controlled market.

Natural gas is extremely important to our industry as feedstock and critical process fuel. We are acutely interested in obtaining natural gas supplies at the lowest price consistent with ensuring long-term deliverability. The distortions of the NGPA make no sense to us. They encourage and reward producers of expensive gas and allow the cost to be passed through to consumers while lower cost gas is being shut in or flared.

Two basic legislative cures for gas market disorder have been proposed. The first is to roll back prices to levels of January 1, 1982, extend NGPA controls, unilaterally abrogate gas contracts and increase the Federal Energy Regulatory Commission (FERC) control on any pipeline price pass through. The theory seems to be that a gas market sickened by regulatory medicine can be cured by a bigger dose of the same. CMA views this extreme approach as a formula for consumer disaster which might lead to modest short-term price decreases but would certainly cause longer-term shortages and higher prices for all consumers.

A sounder legislative initiative, whose basic concepts we support, is S. 615, the Natural Gas Consumer Regulatory Reform Amendments of 1983. This bill offers a good starting point for legislation to address concerns of all gas consumers and the entire economy's concern for adequate and economical future natural gas supplies.

The chemical industry has long been an advocate for natural gas legislation incorporating the following major elements:

- Smooth and orderly transition by a date certain of all natural gas wellhead ceiling prices to market clearing levels;
- Coordinated removal of both supply and demand constraints such as repeal of incremental pricing and the Fuel Use Act; and

- Free market access for all customers, pipelines and distributors to all categories of gas, including gas from the Outer Continental Shelf, that would completely merge the inter and intrastate markets.

There is an urgent need for natural gas consumer regulatory reform amendments to assure adequate gas supplies at competitive prices. All consumers of gas, residential as well as industrial, will benefit from restoring natural gas competition.

- Competitive Natural Gas Production Means Equitable Pricing for All Customers. Competition is the American way to do business whether it is a local store or a national commodity. Natural gas competition will put an end to the consumer penalty of overpriced gas that results from the distortions of government controls.
- Natural Gas Competition Would Lower Energy Costs. Present Natural Gas Policy Act regulations have resulted in production of uneconomic high-priced gas. This contributes to more crude oil imports that eventually will lead to higher world oil prices. A free market will encourage full development of the lowest-cost energy supplies.
- Competition in the Natural Gas Industry Will Improve Our National Economy. Adequate supplies of competitively priced natural gas will make our energy-dependent economy more efficient through the increased production of more goods and services at the lowest cost.

The legislation offered by the Administration is a welcomed major step in the right direction at the right time. The following remarks pertain to S. 615 as introduced.

Title I -- Purchased Gas Costs.

The chemical industry supports the concept that would allow pipelines to recover higher acquisition costs only if the Federal Energy Regulatory Commission approves such recovery. For this concept to work effectively, it is essential that FERC establish an expeditious procedure for reviewing price increase requests. This procedure should not include the application of an absolute ceiling on pricing. In a free market system, prudently incurred cost increases should be allowed to be passed through to the consumer. Appropriate review and approval of prudently incurred costs will avoid market pricing and ordering problems that we have witnessed with the NGPA. This FERC action must be expedited to provide timely market signals to the producers.

If Section 101 is implemented in a rigid and time-consuming manner, it would place an absolute ceiling on average gas prices of each interstate pipeline. This would dampen the renegotiation process and seriously hamper timely establishment of market determined prices.

Title II -- Removal of Wellhead Price Controls and Repeal of Jurisdiction Over Certain First Sales.

We support the timely renegotiation of contracts which were entered into under the distortions of federal regulatory controls. It is essential that existing contract renegotiations be influenced primarily by market considerations with minimum government intervention. Specifically, the gas price cap must not extend past the 12/31/85 date to avoid imposing nonmarket considerations into contract renegotiations.

We support the repeal of Natural Gas Act jurisdiction over first sales of committed or dedicated natural gas. This provision will allow the fullest operation of the market by permitting all gas to be sold to any purchaser upon expiration of existing contracts. This is consistent with a free market's benefits for consumers.

We support repeal of provisions allowing reimposition of price controls. Maximum consumer benefits will only result if renegotiation of contracts is conducted in an environment free from the uncertainty of future government intervention. The threat of continued controls would impede the renegotiation process.

Title III -- Transitional Price and Contract Provisions.

The contract issue is the most difficult problem associated with the natural gas issue. In Title III -- Transitional Price and Contract Provisions -- the bill is designed to facilitate renegotiation of contracts. By providing a relatively short time to renegotiate, market forces will work to keep prices low. Falling oil prices and low gas demand will work to the consumer's benefit. Producers, pipelines, and distribution companies will attempt to maximize deliveries by offering competitive and, therefore, lower prices.

The implementation of a transitional price cap to reflect the current market price for natural gas will eliminate distortions under the NGPA whereby maximum lawful prices acted as "price floors" rather than "price ceilings" and prevented gas prices from responding to downward market pressure. The determination of the price cap is critical and should be calculated on a national basis rather than regionally or pipeline-by-pipeline.

Regarding the "Market-out Provision," the chemical industry believes that sufficient renegotiation will occur during the transition period and any extension could be counterproductive.

With respect to abrogation of contracts, CMA continues to uphold the general concept of contract sanctity and the inappropriateness of government abrogation of privately negotiated "arms-length" contracts. However, it is recognized that the "pipeline contracts issue" that has emerged under the NGPA may be so intractable and inhibiting to the eventual establishment of a free market in natural gas that some government intervention may be justified in the public interest.

Title IV -- Removal of Certain Impediments to Interstate Movements of Gas.

The chemical industry supports the principles for facilitating transportation of nonjurisdictional gas in either isolated or commingled form through pipelines acting as contract carriers. This provision is essential to facilitate supply and demand balancing by market forces. Authorized gas purchases should be equitably transported from purchaser to end user without a restrictive overburden of federal regulations or undue financial penalty to the pipeline or purchaser. It makes sense to treat all categories of gas as a single fungible commodity in purchasing, pricing, transportation and end use.

Title V -- Repeal of Certain Restrictions on Natural Gas and Petroleum Use and Pricing.

The chemical industry strongly supports repeal of the fuel use prohibitions for major fuel-burning installations as provided in S. 615. We further urge that the Powerplant and Industrial Fuel Use Act (FUA) be repealed in its entirety.

The FUA was promulgated under the failed premise that gas and oil would be in increasingly short supply and it has never functioned to reach its stated objectives. While it has little chance of improving energy use patterns, it continues to be an industry planning burden with vast potential for counterproductive results if ever administered as proposed initially by the Economic Regulatory Administration.

The chemical industry also supports repeal of the incremental pricing provisions of the NGPA. These provisions artificially impose higher costs on certain users of natural gas. They have, in fact, raised residential costs by encouraging industrial use of oil as an alternate fuel with the consequent loss of load on interstate pipelines which results in higher unit transportation costs for residential consumers.

Conclusion

In summary, CMA represents a significant class of industrial gas consumers whose well-being, and in some cases, existence, is dependent upon adequate natural gas supplies at fair prices. We identify our needs and aspirations with those of all gas consumers including residential gas consumers. Our needs have not been met by over 20 years of regulation and we believe that consumers would be well served by total elimination of all price and nonprice constraints to the operation of the free gas market. Bills that would freeze or roll back natural gas prices are not in the consumer's long-term interest as they will most certainly discourage investor response to gas demand and create gas shortages. The supporting arguments are similar to those opposing oil deregulation on the basis that deregulation would increase oil prices. Of course, the opposite is true and removal of U.S. controls removed the support for artificial world oil prices.

When the NGPA was passed in 1978, few of us envisioned the distortions that would ravage natural gas consumers just five years later:

- Consumer prices continue to climb at an alarming rate in spite of declining market volume;
- Expensive deep gas and tight sands production is encouraged while low cost gas is shut in; and
- Canada, Mexico and Algeria are rewarded for exporting high cost gas to us while associated gas is flared in this country.

Order must be restored to the natural gas marketplace. Now is the ideal time for Congress to restore the advantages of competition to natural gas for the benefit of all consumers:

- There is a current surplus of natural gas;
- World crude oil prices are declining; and
- Natural gas prices have unnecessarily reached market clearing level of No. 6 fuel oil in most areas of the country.

The Natural Gas Consumer Regulatory Reform Amendments of 1983 provide an excellent starting point for corrective legislation. We must not fear the free market. Supply and demand problems too complex for any of us to predict are readily solved by it. Only two years ago, the opponents of deregulation were making dire prediction of the consequence of deregulating the price of oil in this country. Yet, by every objective measure, that action has been most constructive.

Thank you for the opportunity to appear today. We look forward to working with the Committee on natural gas legislation. I would be pleased to answer any questions.

The CHAIRMAN. Thank you.
Mr. Bryan?

STATEMENT OF RICHARD J. BRYAN, SENIOR ATTORNEY, BURLINGTON INDUSTRIES, ON BEHALF OF THE COUNCIL OF INDUSTRIAL BOILER OWNERS, ACCOMPANIED BY JAN B. VICEK, COUNSEL, CIBO

Mr. BRYAN. I, too, will summarize my written statement. I am Richard J. Bryan, a senior attorney with Burlington Industries and I am here representing the Council of Industrial Boiler Owners, known as CIBO, of which my company is a member.

With me to my right is Jan B. Vicek who is counsel to CIBO.

CIBO is a broad-based association of industrial boiler operators representing 16 major industries independent of public utilities. As natural gas consumers, we are just as concerned about escalating gas costs as the next consumer. But, unlike some, we recognize that these artificially high prices are the result of the market disruptions caused by the Natural Gas Policy Act of 1978.

NGPA and the Powerplant and Industrial Fuel Use Act, sometimes known as FUA—although I have heard others refer to it as "phooey"—were enacted at a time when the Congress and the previous administration believed that the Nation was soon to run out of oil and natural gas.

The whole of the 1977 national energy plan was premised on this dubious assumption. In its wake there was created a multiheaded governmental Frankenstein involving such things as FUA, incremental pricing, taxes on energy consumption, 28 categories of gas, and other endearing devices to encourage the use of this fuel or to discourage the use of that fuel. Like the mythical character, Penelope, we often ended up unraveling by night what we wove by day, subsidizing oil imports, for instance, through the so-called entitlements program and encouraging industry switchovers to oil through incremental pricing, while at the same time discouraging oil use through FUA.

Now the air has somewhat cleared. Talk of fuel shortages has been replaced by talk of bubbles of gas and gluts of oil. Price apparently can now collapse as well as fly up and spike.

OPEC has been revealed for what it is or for what any cartel is in the long run, a house of cards. Now, more than ever, is the time for Congress to put the so-called and largely nonexistent energy crisis of the 1970's behind us by ending market constraints on the use and production of natural gas.

CIBO believes that the administration's natural gas proposal, S. 615, is a constructive approach and we support its basic concepts. In fact, previously CIBO had proposed a three-part program in regard to natural gas which included the orderly phased decontrol of all wellhead gas prices, repeal of incremental pricing, repeal of section 202 of FUA and modification of section 301 to permit prohibition orders to be issued only at the request of the owner of the MFBI.

The administration's bill is in many respects in accord with the program proposed by CIBO. The bill provides for the orderly phased removal of all wellhead price controls over natural gas by a time certain.

Under the current situation, interstate pipelines with low cost, old gas cushions are able to bid up decontrolled deep gas above the cost of competitive fuels by averaging in their low-cost gas.

But in some instances the boiler owner served by intrastate pipelines can purchase only high-cost deep gas. Further distortions occur between boiler owners served by different interstate pipelines who have different low-price cushions and therefore different gas pricing structures.

Reacting to these distortions, boiler owners do one or more of three things, none of which is any good.

They may burn more fuel oil because it is cheaper or more available, thereby making a negative contribution to the national security ramifications of imported oil, strike one.

Or some may convert to alternate fuels unnecessarily or prematurely while others postpone conversion or conservation, strike two.

Or they may locate or relocate operations to regions' advantaged by NGPA pricing distortions or, at the very least, distribute excess manufacturing capacity to the detriment of high-priced gas areas. This is not only inequitable to the jobholder, or perhaps more accurately the ex-jobholder, but it also causes the inefficient use of resources, strike three.

Finally, industrial boiler owners believe that additional supplies of cheaper natural gas will be available once decontrol is achieved as provided in S. 615.

Some persons, such as the panel we heard previous to ours, have stated that, in view of the present situation of sagging demand and surplus supplies, the fact that gas prices are still increasing is proof that the free market and the law of supply and demand do not work. That is preposterous.

Until the day comes when people buy more of something when it becomes more expensive and businessmen make less of something when it becomes more profitable, the law of supply and demand will always work.

What increased prices, in an atmosphere of falling demand and surplus supply, indicate is not that the free market and the law of supply and demand do not work, but rather that there must be some massive, external interference with the functioning of the free market. And we all know what that massive, external interference is.

Second, CIBO supports the administration's attempt to repeal the incremental pricing provisions, title II of the NGPA. This is an action that is long overdue. Indeed, Congress recognized the errors of incremental pricing when it rejected, on a one-House veto, the so-called phase II of the plan, by a 10-to-1 margin in the other body.

The CHAIRMAN. There is a vote on the floor and I am going to have to temporarily suspend the proceedings here. The committee will stand in recess.

[A brief recess was taken.]

Senator MURKOWSKI [presiding]. I call the hearing back in order, and terminate the recess. I would respectfully request that the panel that was interrupted please proceed.

Mr. Bryan, I do apologize for interrupting you and your statement. That does occur one way or the other around here, bells or otherwise. Please proceed.

Mr. BRYAN. Thank you, Senator. I am almost through, and I will complete my comments very shortly. When we recessed, I was speaking of how CIBO supports the efforts of the administration and S. 615 to repeal incremental pricing, and pointed out that a few years ago, this Congress recognized the errors of incremental pricing when it rejected in a House veto the so-called phase two of the plan by a 10-to-1 margin in the other body.

Now let us examine a few of the sins of incremental pricing. First, it contributes to the instability of the natural gas distribution system. Many boiler owners contract for natural gas on an interruptable basis, and accordingly expect to pay a lower price.

Incremental pricing interferes with this price incentive limiting interruptable customers, and, therefore, removing the key device for balancing load between winter and summer. This increases costs to non industrial customers.

Second, incremental pricing is simply inequitable. One of the major problems with incremental pricing is that it inherently and fundamentally unfair, in that it singles out one class, the industrial users, as subject to its arbitrary provisions. The whole scheme is based on the false premise that all business costs are something to be swallowed by overstuffed balance sheets.

The ones that really do the swallowing are the consumers who pay the higher cost of industrial profits, and the unemployed workers who lose out to foreign competition.

Third, incremental pricing hurts the small commerical and residential user. The supreme irony of incremental pricing is that the very class that it is designed to help, the small residential user, ends up paying more in the end.

Because it is the industrial user who has the ultimate fuel capacity, he is the one who is first off the system when natural gas prices increase, as they do under incremental pricing.

As a consequence, less gas is sold, fixed costs have a thinner spread, and the residential user sees his counterfeit savings evaporate. And when he goes to the store, he pays the passthrough costs for consumer products.

To put incremental pricing into perspective, even assuming that there are no switch-overs, that there are no passthrough costs, that fixed costs are not spread thinner, the savings to the average natural gas consumer is less than $1 per month. All this havoc for less than $1 per month.

And finally, CIBO supports the repeal of section 202 of FUA. When FUA was passed during the 95th Congress, the debate then raging was when a reliable supply of natural gas would not longer be available. Even if the assumption of that debate had been true, which it was not, the rationale of FUA was still based on the false premise that the free market works well when supplies were abundant, and it breaks down when scarcities occur.

The selection of appropriate fuels including industrial waste is best evaluated by the boiler user, depending on the individual plant and market conditions. To be most efficient, these decisions must be made in a timely manner. Bureaucratic delay and arbitrary conversion mandates can do nothing to enhance either the efficient use of fuels, job opportunities, or lower prices for industrial goods.

We acknowledge that in the last 2 years DOE has substantially improved its regulations under FUA to correct many of the administrative abuses contained in earlier regulations. But these efforts, as helpful as they are, can only mitigate but not eliminate the necessary and counterproductive statutory constraints embodied in FUA.

In light of today's improved supplies of natural gas, and the total supply balance that will occur under decontrol, no serious argument can be made on the current FUA prohibition on the use of gas and new facilities, and the authority to order mandatory gas to coal conversions, that it had any useful purpose.

To summarize our position then, CIBO supports the basic framework of S. 615, particularly those sections which provide for the phased decontrol of all wellhead price controls over natural gas by a time certain. We support repeal of incremental pricing, and repeal of those sections of FUA that we outlined.

Similarly, we oppose adamantly all bills that provide the quick fix price freezes or extend controls.

I thank you for the opportunity to appear before this committee today, and would be happy to answer any questions.

[The prepared statement of Mr. Bryan follows:]

STATEMENT OF RICHARD J. BRYAN, SENIOR ATTORNEY, BURLINGTON INDUSTRIES, INC., ON BEHALF OF THE COUNCIL OF INDUSTRIAL BOILER OWNERS

I am Richard J. Bryan, Senior Attorney with Burlington Industries, Inc., and am here representing The Council of Industrial Boiler Owners ("CIBO"), of which my company is a member. CIBO is a broad-based association of industrial boiler operators representing sixteen major industries independent of public utilities. As natural gas consumers we are just as concerned about escalating gas costs as the next consumer, but, unlike some, we recognize that these artificially high prices are the result of the market disruptions caused by the Natural Gas Policy Act ("NGPA") of 1978.

NGPA and the Powerplant and Industrial Fuel Use Act ("FUA") were enacted at a time when the Congress and the previous administration believed that the nation was soon to run out of oil and natural gas. The whole of the 1977 National Energy Plan was premised on this dubious assumption; in its wake there was created a multi-headed governmental Frankenstein involving such things as FUA, incremental pricing, taxes on energy consumption, twenty-five categories of gas, and other endearing devices to encourage the use of this fuel or to discourage the use of that fuel. Like the mythical character Penelope, we often ended up unraveling by night what we wove by day, subsidizing oil imports, for instance, through the so-called "entitlements" program and encouraging industry switchovers to oil through incremental pricing, while at the same time discouraging oil use through FUA.

Now the air has somewhat cleared. Talk of fuel shortages has been replaced by talk of "bubbles" of gas and "gluts" of oil. Price apparently can now collapse as well as "fly up" and "spike." OPEC has been revealed for what it is -- or what any cartel is in the long run -- a house of cards. Now, more than ever, is the time for Congress to put the so-called and largely non-existent energy "crisis" of the 70's behind us, by ending market constraints on the use and production of natural gas.

CIBO believes that the Administration's natural gas proposal, S. 615, is a constructive approach, and we support its basic concepts.

Previously, CIBO had proposed a three-part program in regard to natural gas, which included:

(1) Orderly phased decontrol of all wellhead gas prices;

(2) Repeal of incremental pricing;

(3) Repeal of Section 202 of FUA and modification of Section 301 to permit prohibition orders to be issued only at the request of the owner of the MFBI.

The Administration's bill is in many respects in accord with the program proposed by CIBO. The bill provides:

A. Orderly Phased Removal of All Wellhead Price Controls Over Natural Gas by a Time Certain.

Under the current situation, interstate pipelines with low cost, old gas cusions are able to bid up decontrolled deep gas above the cost of competitive fuels by averaging in their low cost gas. But in some instances the boiler owner served by intrastate pipelines can purchase only high cost, deep gas. Further distortions occur between boiler operators served by different interstate pipelines who have different low priced cushion and therefore different gas pricing structures.

Reacting to these distortions, boiler owners do one or more of three things, none of which is any good:

They may burn more fuel oil because it is cheaper or more available, thereby making a negative contribution to the national security ramifications of imported oil. Strike one.

Some may convert to alternate fuels unnecessarily or prematurely, while others postpone conservation or conversion. Strike two.

Or, they may locate or relocate operations to regions advantaged by the NGPA pricing distortions, or at the very least, distribute excess manufacturing capacity to the detriment of high-priced gas areas. This is not only inequitable to the job-holder -- or, perhaps more accurately, the ex-job-holder -- but it also causes the inefficient use of resources. Strike three.

Finally, industrial boiler owners believe that additional supplies of cheaper natural gas will be available once decontrol is achieved as provided in S. 615. Some persons have stated that in view of the present situation of sagging demand

and surplus supplies, the fact that gas prices are still increasing is proof that the free market and the law of supply and demand do not "work." That is preposterous; until the day comes when people buy more of something when it becomes more expensive and businessmen make less of something when it becomes more profitable, the law of supply and demand will always "work." What increased prices in an atmosphere of falling demand and surplus supply indicate is not that the free market and the law of supply and demand do not "work," but rather that there must be some massive external interference with the functioning of the free market. And we all know what that "massive external interference" is.

B. Repeal of the Incremental Pricing Provisions (Title II) of NGPA.

The repeal by S. 615 of incremental pricing is an action that is long overdue. Indeed, Congress recognized the errors of incremental pricing when it rejected (on a one-house veto) the so-called "Phase II" of the plan by a 10-1 margin in the other body. Let us examine some of the sins of incremental pricing:

(1) It contributes to the instability of the natural gas distribution system. Many boiler owners contract for natural gas on an interruptible basis and accordingly expect to pay a lower price. Incremental pricing interferes with this price incentive, limiting interruptible customers, and thereby

removing the key device for balancing pipeline load between winter and summer. This increase costs to the non-industrial customer.

(2) Incremental pricing is inequitable. One of the major problems with incremental pricing is that it is inherently and fundamentally unfair in that it singles out one class, the industrial users, as subject to its arbitrary provisions. The whole scheme is based on the false premise that all business costs are something to be swallowed by overstuffed balance sheets. The ones who really do the swallowing are the consumers who pay the higher cost of industrial products, and the unemployed workers who lose out to foreign competition.

(3) Incremental pricing hurts the small commercial and residential user.

The supreme irony of incremental pricing is that the very class it is designed to help -- the small residential user -- ends up paying more in the end.

Because it is the industrial user who has the alternate fuel capacity, then it is the one who is first off the system when natural gas prices increase, as they do under incremental pricing. Less gas is sold, fixed costs have a thinner spread, and the residential user sees his counterfeit savings evaporate. And when he goes to the store he pays the pass through costs for consumer products.

To put incremental pricing in perspective, even assuming no switch-overs and no passed-through costs, the savings to the average natural gas consumer is less than one dollar a month. All this havoc for less than one dollar a month!

C. Repeal of Section 202 of FUA.

S. 615 properly addresses the need to repeal the Powerplant and Industrial Fuel Use Act of 1978.

When FUA was passed during the 95th Congress, the debate then raging was when a reliable supply of natural gas would no longer be available. Even if the assumption of the debate had been true, which it was not, the rationale of FUA was still based on the false premise that the free market works well when supplies are abundant but breaks down when scarcities occur.

The selection of appropriate fuels, including industrial wastes, is best evaluated by the boiler user depending on the individual plant and market conditions. To be most efficient, these decisions must be made in a timely manner. Bureaucratic delay and arbitrary conversion mandates can do nothing to enhance either the efficient use of fuels, job opportunities or lower prices for industrial goods.

We acknowledge that in the last two years, DOE has substantially improved its regulations under FUA to correct many of the administrative abuses contained in earlier regulations. But these efforts, as helpful as they are, can only mitigate, not eliminate the unnecessary and counterproductive statutory constraints embodied in FUA.

In light of today's improved supplies of natural gas and the total supply balance that will occur under full decontrol, no serious argument can be made that the current FUA prohibition on the use of gas in new facilities, and the authority to order mandatory gas-to-coal conversions, has any useful purpose.

Summary

CIBO supports the basic framework of S. 615, particularly those sections which provide for the:

(1) Orderly phased decontrol of all wellhead price controls over natural gas by a time certain;

(2) Repeal of the incremental pricing, Title II of the Natural Gas Policy Act of 1978;

(3) Repeal of the Powerplant and Industrial Fuel Use Act of 1978.

Sinilarly, we oppose bills that freeze prices or extend controls.

STATEMENT OF
RICHARD BRYAN ON BEHALF OF
THE COUNCIL OF INDUSTRIAL BOILER OWNERS

I am Richard J. Bryan, Senior Attorney with Burlington Industries, Inc. and I am testifying on behalf of The Council of Industrial Boiler Owners ("CIBO"). With me is Jan B. Vlcek of Sutherland, Asbill and Brennan, counsel to CIBO and William B. Marx, President of CIBO. CIBO is a broadbased association of industrial boiler operators and related equipment manufacturers, representing sixteen major industries, independent of public utilities. CIBO was formed in 1978 to encourage the maximum exchange of relevant information among its members and between industry and government to assure that public policy in the fuel utilization and environmental areas is realistic in light of the contribution to our economy of industrial boiler users and their support of the free market.

CIBO believes that the central goal of national energy policy should be to maximize the reliance on free market mechanisms, the most efficient means of encouraging the development of domestic energy supplies and assuring the optimum allocation of these resources. To that end, CIBO believes that the government should pursue an aggressive and coordinated program aimed at removing the remainder of the maze of energy regulatory programs.

The Natural Gas Policy Act and the Powerplant and Industrial Fuel Use Act ("FUA") were enacted at a time when shortages caused by Federal price controls on natural gas led the Congress and the previous administration to believe that the nation was soon to run out of natural gas and thus increase its dependence on imported oil. The whole of the 1977 National Energy Plan was premised on this assumption and involved a series of governmental mandates and incentives, such as the FUA, incremental pricing, and taxes on energy consumption, to force or encourage use of fuels other than gas or petroleum.

Given the present potential for the improved outlook for natural gas if nonmarket constraints on use and production are removed, and the declining dependence on uncertain oil supply from foreign sources, we believe the Congress must, in the national interest, remove the major impediments to the use of natural gas and domestic oil.

Experience with these energy programs conclusively demonstrates that they must be replaced with an approach which relies on the free market to achieve sound energy policy.

Consistent with this basic principle, the Council of Industrial Boiler Owners (CIBO) supports the basic concepts of S.615, the Administration's natural gas proposal and strongly opposes "quick fix" proposals to extend regulations and increase intervention in the marketplace in the form of legislation such as S.291, S.293 and S.689 that would extend controls and freeze prices and would create futures shortages and higher prices in the long run. CIBO believes that the free market is the most efficient means of encouraging development of the domestic energy supplies and assuring the optimum allocation of energy resources. The concepts of S.615 are in harmony with CIBO objectives for achieving a gas market free of supply and demand constraints and we support those concepts. S.615 is itself a compromise between the increased market intervention on the one hand and phased total deregulation by date certain on the other. As such, CIBO believes that the Administration's proposal provides the basis for a coordinated approach that is required to modify counterproductive energy legislation and to move toward true intra fuel competition. CIBO has proposed a three part program to accomplish this which included:

1. Modification of Title I of the Natural Gas Policy Act of 1978 to provide an orderly phased decontrol of all wellhead price controls over natural gas.
2. Repeal of Title II of the Natural Gas Policy Act.
3. Repeal of Section 202 of the Powerplant and Industrial Fuel Use Act of 1978 and modification of Section 301 to permit MFBI prohibition orders to be issued only at the request of the owner of the MFBI.

S.615 is in many respects in accord with the program proposed by CIBO:

1. CIBO advocates orderly phased deregulation of all wellhead prices. S.615 provides for decontrol of all wellhead price controls on natural gas and does this in an "orderly" fashion by adding to NGPA's 1985 deregulation of certain gas, a removal of price controls on remaining natural gas by January 1,

1986; at the same time providing incentives for mutual renegotiation of contracts to eliminate the high prices and extreme take-or-pay clauses that have resulted from the disparties in the marketplace created by the NGPA.

2. The Administration proposal provides for the immediate repeal of incremental pricing which CIBO considers to actually have the potential of raising average transmission costs bourne by residential consumers as boiler users are driven off the system.

3. The Administration's proposal provides for the immediate repeal of Section 202 of the Powerplant and Industrial Fuel Use Act of 1978.

With respect to the latter, S.615 does not retain the authority of the Department of Energy to issue prohibition orders at the request of the owner of an industrial steam generating facility who wishes to convert to coal. This is an addition which we would urge and for which we have provided specific language.

A. Orderly Phased Removal of All Wellhead Price Controls Over Natural Gas by a Time Certain

Since the Subcommittee will hear from many witnesses in detail on the problems encountered with Title I of the NGPA, CIBO would like to confine its remarks to several broad areas of particular concern to boiler fuel users.

Under the current situation, interstate pipelines with low cost old gas cushions are able to bid-up decontrolled deep gas above alternate fuel value by averaging their low cost gas and deep gas purchases in average sales prices. In some instances, the boiler operator served by intrastate pipelines can purchase only high cost, deep gas or switch to an alternate fuel if an alternate fuel capability exists. Further distortions occur between boiler operators served by different interstate pipelines who have different low priced cushion and therefore different gas pricing structures. Since only partial deregulation is scheduled to occur in 1985, these distortions will continue as long as flowing gas remains under controls.

Because of these distortions, some boiler owners lose while others gain. These losses and gains cannot be attributed to a deficiency or presence of internal management skill, but rather to inequitable and unnecessary government intervention in the natural gas marketplace. Obviously, previously established competitive balances are upset as some boiler owners "win" and others "lose". In the extreme this will result in the transfer of jobs from one region to another without any gain to the nation as a whole.

These pricing distortions will cause adversely affected boiler owners to react by:

a. Burning more fuel oil either because it is cheaper or it is available (industrial boilers would be among the first to be curtailed if natural gas shortages were to return). Obviously, oil imports will increase.

b. Converting to alternate fuels unnecessarily or prematurely. Some disadvantaged boiler owners will be forced to convert to alternate fuels, justified by a "paper payout" with inefficient utilization of their available capital. Conversely, advantaged boiler owners with their underpriced gas are not encouraged to conserve or convert. Consequently, the economy loses twice, as disadvantaged owners convert prematurely or unnecessarily, and advantaged owners forego valuable conservation opportunities.

c. Shutting down or relocating operations to regions advantaged by the NGPA pricing distortion. This, too, is economically inefficient. While total shutdowns will be limited, partial transfers of operations are very likely, since excess production capacity exists in most industries in today's recession.

Finally, industrial boiler owners believe that additional supplies of natural gas will be available if wellhead prices are totally deregulated as provided in S.615. Indeed sufficient quantities available at prices low enough would make boiler conversion unnecessary, conserving capital for true productivity increases of benefit to the economy. In addition, delayed boiler conversions would also ease air pollution. In the worst case, if insufficient natural gas is produced by deregulation, prices will rise and boiler conversions will occur in an orderly and efficient manner. In fact, even in this pessimistic scenario, economic efficiency will be greater than it is under the status quo.

B. Repeal of the Incremental Pricing Provisions of the Natural Gas Policy Act of 1978

The repeal by S.615 of Title II of the NGPA is constructive public policy for the following reasons:

--Incremental Pricing Severely Undermines the Boiler Fuel Use Contribution to the Stability of the Natural Gas Distribution System

Many boiler owners contract for natural gas on an interruptible basis, allowing the distribution companies to stop delivery during periods of peak demands. Thus, they anticipate being curtailed part of the time. They enter into these interruptible contracts realizing that such an arrangement will benefit both the gas distributor and themselves. Since boiler owners with interruptible contracts do not require continuous service and are willing to be interrupted, they expect to, and should, pay a lower price for their natural gas than customers with an assured delivery on demand.

Most residential and commercial natural gas use is for space heating and is consequently highly seasonal in its demand pattern. If distribution companies do not have interruptible customers, their pipelines would run partially empty during the nonheating season. If they add additional high priority users to replace their interruptible contract volume, they will have to add storage capacity to help meet the added peak demand of the heating season. Either situation will increase the cost for both the distribution company and their remaining customers.

In the former, the pipeline fixed cost must be distributed over a significantly smaller volume of gas, thereby increasing the unit cost to the remaining customers without providing them with any additional benefit. In the latter case of increased storage capacity, the capital burden of the distribution company will be increased which again will result in an increase in the unit cost of natural gas to the remaining customers in order for them to maintain the same level of service. In both cases, distribution companies and pipelines that lose a substantial portion of their interruptible contract customers, will be forced to charge significantly higher prices to their other customers without any change in service.

Incremental Pricing is Inequitable

One of the major problems with incremental pricing is that it is inherently and fundamentally inequitable. It singles out one class, the industrial users, as subject to its arbitrary provisions. Thus, electric utilities who compete with industrials for natural gas supplies are not subject to incremental pricing. This is inherently unfair.

Incremental Pricing Schemes, Such as Title II of NGPA, are Counterproductive to the Goal of Protecting Residential and Small Users

Such schemes assume that large boiler use is "inferior," presumably because of the actual or potential ability of large boilers to use alternate fuels. If the test for "inferior" is alternate fuel capability, why are homeowners, hospitals, schools and small commercial users, generally categorized as high priority, for they too can convert to alternate fuels? The answer is -- the cumulative cost for the high priority users to convert is believed to be excessive compared to the cost of larger users, such as utility or industrial boiler owners, because of their economies of scale.

Therefore, if this presumption is true, when the rolled in price of natural gas increases for any reason, the first users off the system will be boiler owners, since they are most sensitive to a price increase, valuing natural gas service the least. The initiation of a marginal pricing or an incremental pricing scheme only serve to accelerate this process by causing some boiler owners, perhaps most, who are not otherwise restricted by a lack of capital, high interest rates or environmental restraints, to prematurely convert to an alternate fuel.

Such conversions are expensive and time-consuming and divert capital to projects justified only by regulatory fiat and not by true market forces. Although these projects will not benefit the boiler owners, their shareholders, nor the nation as a whole, they will absorb scarce capital, increase air emissions and reduce pipeline offseason sales and base loads. Thus, they will increase the fixed costs to be shared by the remaining pipeline customers and result in some pipeline capacity being unused. Finally, this causes pipelines and distribution companies to install additional storage capacity for their seasonal users. Ironically, these adverse economic impacts will be passed through to these same high priority users either directly or indirectly.

Furthermore, why should natural gas high priority users be subsidized while others using fuel oil, coal, wood, or electricity for the same purpose are not subsidized? In fact, there will be quite a different result as those using fuel oil, wood, coal, and electricity will be further disadvantaged as boiler owners convert to those fuels and increase the demand and hence, the price for those alternate fuels. This will cause high priority users that do not consume natural gas to further contribute to the subsidy enjoyed by those using it.

Marginal or incremental pricing schemes are without merit. What they attempt to do can better be done by market forces. High priority and low priority uses are in reality a comparative assessment of the economic value users place on their supply. If these assessments are indeed accurate there is no need to protect them from supply and demand economics that already operate each and every day in almost all areas of our country. If the price of natural gas increases, low priority users will switch and the supply/demand balance will be restored. High priority users are already -- and quite properly -- protected against volumetric shortages and emergency conditions by existing curtailment priorities. If the capacity of a pipeline or distribution company is temporarily inadequate, boiler owners can and will switch to alternate fuels. The ultimate irony is that now just five short years after enactment of the NGPA pipelines are petitioning the FERC for "incentive" rate structures that would offer lower rates for users with No. 6 fuel oil alternate fuel capability. Of course, the preponderance of such users are those same boiler owners targeted for higher rates under phase I of incremental pricing of the NGPA. This dramatic reversal has resulted from several factors. First pipelines imprudently purchased significant quantities of high priced gas believing that their customers would pay any price for gas and thereby increased their average gas price above No. 6 fuel oil. Second, conservation by all gas users has continued as a natural and expected response to natural gas price increased that have averaged nearly 20% annually for the last nine years, and, third, the weakened state of the economy hs resulted in many industries operating well below production levels of just a few years ago.

C. Repeal of Section 202 of the Powerplant and Industrial Fuel Use Act of 1978

S. 615 properly addresses the need to repeal the Powerplant and Industrial Fuel Use Act of 1978. This repeal is amply supported by the experience to date under the Act.

1. The 1978 Fuel Use Act Versus the 1982 Fuels Situation

When the Fuel Use Act was passed during the 95th Congress, the debate then raging was when a reliable supply of natural gas would no longer be available. Even if the assumption of the debate had been true, which it was not, the rationale of the Fuel Use Act was still based on the false premise that the free market works well when supplies are abundant but breaks down when scarcities occur. Indeed, the free market is at its dynamic best when scarcities appear, immediately flashing out signals through higher prices that create incentives for both conservation and the development of new supplies and substitutes. The real problem was disparity in prices between regulated gas in the interstate market and unregulated gas in the intrastate market, which caused the interstate market to face several years of serious shortages. Today, however, the supply demand balance for natural gas looks more positive. If non-market constraints are removed, the supply picture will further improve substantially.

In light of the potential for improved supplies of natural gas, and in view of the high cost of retrofitting existing industrial facilities, it can no longer be argued that the current FUA prohibition on the use of gas or oil in new facilities, and the authority to order mandatory gas-to-coal conversions is necessary or justifiable. Therefore, the current FUA authority to order mandatory gas-to-coal conversion for existing MFBI's should be eliminated, thereby removing the prospect of costly retrofitting that often will not be justified in light of improved gas availability. Only authority to issue orders requested by MFBI owners, as currently provided for utilities, should be retained.

The selection of the appropriate fuel(s), including industrial wastes, is best evaluated by the boiler user depending upon the individual plant and market circumstances. Although many of those circumstances are those for which the Fuel Use Act provides exemptions, the uncertainty and delays associated with the exemption process have slowed industry's efforts to replace older, less efficient gas and oil-fired units with new and more efficient units, to increase the use of alternate fuels such as industrial waste by-products, and to postpone or cancel plant expansions designed to use fuel more efficiently.

2. The Failure of FUA; the Need for Repeal Versus Regulatory Relief

Some may contend that many of the current problems are the result of the unlawful and excessive regulations issued in the past by DOE; a problem which the Reagan Administration has in part corrected as part of its strong commitment to regulatory reform. While we commend the improvements made through the administrative process, we believe that regulatory changes alone cannot address the fundamental problems with the current Act. The basic flaw in the Act - the insertion of the government into the industrial fuels decision process - cannot be rectified by administrative action. By imposing a statutory prohibition on the use of gas and oil in new MFBI boilers, and leaving the exemption process to the Economic Regulatory Administration, the Act improperly substitutes the judgment of remote, inexperienced DOE employees, for the experienced decisionmaking of industrial managers, who are directly responsible for the economic and efficient operation of industrial facilities.

In the last two years, DOE has substantially improved its regulations under the Fuel Use Act to correct many of the administrative abuses contained in earlier regulations and to conform more closely to the intent of Congress in enacting FUA. These efforts, as helpful as they are, can only mitigate, not eliminate, the unnecessary and counterproductive statutory constraints embodied in the Fuel Use Act. Importantly, these regulatory corrections could just as easily be undone by subsequent Administrations. Furthermore, in making fuel selection decisions, industry must make economic and regulatory projections extending far into the future. Thus, the statutory prohibition on fuel use and mandatory conversion order authorities that still exist under FUA have a chilling effect on planning for optimum industrial energy efficiency through conversion and conservation. Changes in regulations, while certainly helpful, simply do not provide the same degree of certainty as would be provided by repeal.

Basically stated, the Fuel Use Act is not necessary to achieve efficient use of natural gas or oil.

Meanwhile, the Act continues to be an obstacle to the increased use of alternate fuels in new industrial boilers. In one case, decided last year, a petitioner sought to obtain permission from DOE to use natural gas in a mixture with a low Btu fuel, which would reduce overall boiler fuel consumption of natural gas at the plant by approximately 7%. In that case, the company requested permission to use natural gas in two new boilers and to shut down 30 less-efficient natural gas-fired units at the site. The company also asked for permission to use natural gas when the waste fuel was not available due to shutdown of the process equipment generating the waste fuel.

Even though DOE did not dispute the petitioner's claim that grant of the exemption as proposed could save approximately one million Mcf of natural gas per year, DOE issued a proposed decision which would have denied, in part, the company's request to use the boilers at full capacity and operate them during periods when waste fuels were temporarily unavailable. Based on this proposed negative filing, the petitioner ultimately withdrew the portion of its petition which requested authorization to use natural gas during these periods.

Moreover, even after DOE's adoption of its revised regulations in December 1981 and November 1982, which was intended to reduce the scope of the program, companies still are required to incur substantial cost for preparation of petitions for exemption for new facilities. Furthermore, they experience costly delays in obtaining authority to commence operation, due in part to procedural delays built into the statute. During 1982, petitions for exemption were filed or acted on for 17 MFBI's ranging from relatively brief fuel mixtures exemptions to more complex site limitations, cogeneration cost, and reliability of service exemptions, and a number of additional petitions are likely to be filed shortly. Eleven petitions for modification of past exemption orders were also filed. The regulatory costs of this program, even though substantially less now than before, are indefensible, given the absence of any need for or benefits from the program.

Conclusion

As indicated above, CIBO supports the basic framework of S.615, the Administration's natural gas proposal particularly as it provides for:

1. Orderly phased decontrol of all wellhead price controls over natural gas by a time certain;

2. Repeal of the incremental pricing provisions of the Natural Gas Policy Act of 1978; and

3. Repeal of the mandatory prohibition provisions of the Powerplant and Industrial Fuel Use Act of 1978.

Similarly we oppose "quick fix" bills that freeze prices or extend controls.

This concludes our prepared statement.

Senator **Murkowski**. Thank you, very much, Mr. Byran.

Mr. McNamara, I believe your presentation is next. Please proceed.

STATEMENT OF PATRICK H. McNAMARA, DOW CHEMICAL CO., AND COCHAIRMAN, PETROCHEMICAL ENERGY GROUP

Mr. **McNamara**. Thank you, Mr. Chairman.

In PEG's view, S. 615 represents a comprehensive and balanced solution to the natural gas problem, and merits favorable consideration by this committee. I say comprehensive, because all major issues are addressed.

Table 1 attached to your testimony is our attempt to analyze what the plan is. It can be divided into three categories; deregulation, contracts, and additional consumer factors. I will briefly discuss each in turn.

First, deregulation. This bill does get the Federal Government out of the business of deciding how much various categories of gas should cost, deciding who can and who cannot buy gas in the field, and deciding what terms will be required in wellhead sales contracts.

Deregulation is essential, because the cushion of old price-controlled gas resulting from Federal regulation is the No. 1 cause of the current and projected natural gas disorders. This bill provides an orderly method for mitigating the cushion.

Second, contracts. The bill also addresses the contract problem. Some of us have been skeptical of those who sign contracts, and then ask the Federal Government to bail them out. Claims of those currrently seeking various contract fixes are even worse.

The proponents would make a more audacious plea. They do not ask to be bailed out of a contract. Rather they want to keep all of the benefits that they bargained for, but be relieved of their side of the bargain by the Federal Government.

In S. 615, however, those who want out of contracts are let out, all right, but both sides are released.

And third, additional consumer factors. The third major component of the bill is truly staggering, and truly impressive. Some have called for more Federal regulation to prevent gas prices from rising.

Well, this plea was heard, for the bill contains constraints on gas prices, constraints more punitive than I can recall hearing advocated before the committee in recent hearings.

As a representative of a consumer group within the largest category of gas consumers, who did not advocate harsh and punitive restraints, I wish those who did would reconsider.

Severe pressure is applied to the pipelines and to the producers. We note that this bill prevents a pipeline from collecting some purchased-gas costs in its FERC-approved rates until after a hearing.

There is no provision for collection subject to refund, and no provision for retroactive collection. This means that a pipeline can act prudently and without committing fraud, abuse, or similar grounds, and still suffer a severe financial penalty.

Not even the Natural Gas Act of 1938 is this tough. We must acknowledge a certain fear of overkill here. This brings me to another point.

The bill is balanced. Each set of principles relating to deregulation in contracts has mutuality. No party to a contract can invoke a provision of the bill without risk that the other party will also invoke the same or a different balancing provision.

For example, some claim that pipelines have entered into contracts with too high a take-or-pay obligation. So the principle here is, let the pipeline making the claim unilaterally limit that contractual provision, if it wishes to do so.

But in fairness, let the producer take the shut-in gas and sell it elsewhere, if he chooses to do so, and require the pipeline to unilaterally rescind it, to provide access to another market.

Either party to a contract may rescind on 1185, a perfect balance. No advantage to one side or to the other. Neither party to a contract is bound to deal only or first with a federally designated party. Again, balanced.

Competition for gas supply in the field is open. There are no more monopolies, monopsories, or special privileges doled out by the Federal Government. All may compete in all gas fields, interstate pipelines, intrastate pipelines, distribution companies, electric utilities, industrial users. Again, there is balance.

If a distributor, for example, is dissatisfied with the policies of its pipeline supplier, it can bypass the pipeline, and acquire its own supply. But if an industrial or an electric utility is dissatisfied with the policies of its pipeline or its distributor, it also can bypass one or both. Again, balanced.

We might note, however, that the bill apparently does not compel distribution companies and other pipelines exempt from FERC jurisdiction to transport. But this is perhaps in deference to State jurisdiction.

Hopefully, these examples will suffice. What emerges, of course, is the largest balance of them all, the consumer of gas, whether residential, commercial, electric utility, or industrial is insulated from any risk that the situation will get worse than under the NGPA.

No price increases above the NGPA schedule of prices are mandated. After 1985, no high-cost gas need be bought, no indefinite price escalator in any contract can operate, no take-or-pay provision in part or in whole can operate unless each pipeline chooses to allow any or all of them to remain effective.

And those dependent on the pipeline, interstate and intrastate alike, whether distributor or user, can avoid the pipeline's decision and beat its prices, if they wish to attempt to do so.

In addition, the cushion of price-controlled gas has the optimum chance of ordering balancing, so that the range of gas prices in the country will moderate. And we will not see the market chaos so well illustrated by Federal data in the electric utility industry.

Just to conclude these, I would say that we believe that the solution to the Nation's pressing natural gas problem must be achieved. The objective should be to bring the average price of gas at the wellhead to a market clearing level, and to eliminate all cushions and preferences caused by Federal controls.

To this end, we believe that S. 615 merits favorable consideration by this committee. Thank you.

Senator **MURKOWSKI**. Thank you, Mr. McNamara.

[The prepared statement of Mr. McNamara follows:]

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Testimony of Patrick H. McNamara

Thank you Mr. Chairman. I am Patrick H. McNamara, Manager of Government Relations - Hydrocarbons and Energy, The Dow Chemical Company and Co-chairman of the Petrochemical Energy Group (PEG). With me today is Gordon Gooch of Baker & Botts. Following my statement we will both be pleased to answer any questions. I was asked by PEG to present this testimony in response to the Committee's call for comments on certain pending legislation. I will devote most of my comments to S. 615 introduced by the Chairman.

In PEG's view, S. 615 presents a comprehensive and balanced solution to the natural gas problem and merits favorable consideration by this Committee.

Comprehensive Solution

I say "comprehensive" because all major issues are addressed. Table 1 is our attempt to analyze what the plan is: it can be divided into three categories: deregulation, contracts, and additional consumer factors. I will discuss each in turn.

Deregulation. This bill does get the federal government out of the business of deciding how much various categories of gas should cost, 1/ deciding who can and cannot buy gas in the field, 2/ and deciding what terms will be required in wellhead sales contracts. 3/ Deregulation is essential because the "cushion" of old, price controlled gas resulting from federal regulation is the number one cause of the current and projected natural gas disorders. This bill provides an orderly method of mitigating the cushion.

Contracts. The bill also addresses the "contract problem." Some of us have been skeptical of those who sign contracts and then ask the federal government to bail them out. Claims of those currently seeking various contract "fixes" are even worse. The proponents make a more audacious plea. They don't ask to be bailed out of a contract; rather, they want to keep all of the benefits they bargained for but be relieved of their side of the bargain by the federal government. In S. 615, however, those who want out of contracts are let out all right, but both sides are released. 4/

Additional Consumer Factors. The third major component of the bill is truly staggering. Some have called for more federal regulation to prevent gas prices from rising. Well, this plea was heard, for the bill contains constraints on gas prices, 5/ constraints more punitive than I can recall hearing advocated before the committee in recent hearings. As a representative of a consumer group within the largest category of gas consumers, who did not advocate harsh and punitive constraints, I wish those who did would reconsider.

Severe pressure is applied to the pipelines and to the producers. We note that this bill prevents a pipeline from collecting some purchased gas costs in its FERC approved rates until after a hearing. 6/ There is no provision for collection subject to refund and no provision for retroactive collection. 7/ This means that a pipeline can act prudently and without committing fraud, abuse, or similar grounds and still suffer a severe financial penalty. Not even the Natural Gas Act of 1938 is this tough. 8/

We must acknowledge a certain fear of overkill here. But, the objective is clear enough. The interstate pipelines--where the cushion is greatest--are constrained in the renegotiation process, which, mercifully, will be over on January 1, 1986, by the purchased gas cost passthrough restriction. 9/ During this process, gas prices at the wellhead to the producer in existing contracts will be limited by a superseding price ceiling based upon a "market" price for gas--or the applicable NGPA prices, whichever is lower. 10/

In summary, the bill achieves deregulation of wellhead sales, provides a complete solution to the contract problem, however perceived, and provides rather formidable barriers to some cost increases in rate cases, which may be called consumer protection. All sides were heard; all interests got what they asked for affirmatively and no side was given a free shot at another side.

Balanced Application

This brings me to the second point: the bill is balanced. Each set of the principles relating to deregulation and contracts has mutuality. No party to a contract can invoke a provision of the bill without risk that the other party will also invoke the same or a different balancing provision. For example, some claim that pipelines have entered into contracts with too high a take-or-pay obligation. So, the principle here is, let the pipeline making the claim unilaterally limit that contractual provision, if it wishes to do so. But, in fairness, let the producer take the shut in gas and sell it elsewhere, if he choses to do so, and require the pipeline who unilaterally rescinded to provide access to another market. 11/

The ceiling prices for § 107 gas--the deep deregulated and the regulated high cost--are not rolled back by the legislation. 12/ But, as a balancing factor, the § 104 ceiling price--interstate flowing gas--is not raised by the bill and, indeed, may be rolled back by the bill. 13/

The jurisdiction of the FERC to lower the § 107 regulated price and the FERC jurisdiction to raise the § 104 price (*et al*.) is left intact. 14/ This, too, is balance.

Either party to a contract may rescind on 1/1/85. 15/ Perfect balance. No advantage to one side or another.

Neither party to a contract is bound to deal only or first with a federally designated party. 16/ Again, balance.

Competition for gas supply in the field is open--there are no more monopolies, monopsonies, or special privileges doled out by the federal government. All may compete in all gas fields--interstate pipelines, intrastate pipelines, distribution companies, electric utilities, industrial users 17/--anyone--which, again, is balance. If a distributor, for example, is dissatisfied with the policies of its pipeline supplier, it can bypass the pipeline and acquire its own supply. 18/ But if an industrial or electric utility is dissatisfied with the policies of his pipeline or his distributor, it can bypass one or both. 19/ Again, balance. (We might note, however, that the bill apparently does not compel distribution companies and other pipelines exempt from FERC jurisdiction to transport, 20/ but this is perhaps in deference to state jurisdiction).

With respect to take-or-pay there are really two balances: one, since the pipeline has the unilateral right to abrogate part of the contract, the producer has the corresponding right to take back and sell the gas shut in by the abrogation; 21/ two, the pipeline is severely--even punitively--limited in its takes from its own production or from an affiliate, 22/ so the pipeline can't shut in an independent producer in order to benefit itself. (We do note a possible omission with respect to imports such as those covered in S. 370). 23/

Hopefully, these examples will suffice.

What emerges, of course, is the largest balance of them all. The consumer of gas--whether residential, commercial, electric utility, or industrial is insulated from any risk that his situation will get worse than under the NGPA. No price increases above the NGPA schedule of prices are mandated. 24/ After 1985 no high cost gas need be bought, no indefinite price escalator in any contract can operate, no take-or-pay provision, in part or in whole, can operate--unless each pipeline company chooses to allow any or all to remain effective; 25/ and, those dependent on the pipeline--interstate and intrastate alike--whether distributor or user--can avoid the pipeline's decision and beat its prices, 26/ if they wish to attempt to do so.

The Cushion Problem and Market Disorder

In addition, the cushion of price controlled gas has the optimum chance of orderly balancing, so that the range of gas prices in the country will moderate, and we will not see the market chaos so well illustrated by federal data in the electric utility industry. 27/

PEG testimony presented in July, 1982 before a Committee of the House of Representatives 28/ discussed the seriousness of the cushion problem and provided information updating PEG's discussion of that problem before this Committee in March of 1982. 29/ I ask that the July statement be incorporated by reference with my statement today. It illustrates the problem using data from the 20 major interstate pipelines developed by EIA. To briefly summarize, the cushion makes it possible for some pipelines to bid higher prices than they could if there were no cushion. Or, in AGA's recent words, "purchases of Section 107 gas to date show that most pipelines have 'used' part of their cushions to purchase decontrolled gas at above a free market price." 30/

Moreover, the cushion is not evenly distributed. An EIA report, 31/ discussed in PEG's July testimony, shows the wide range of average prices among the 20 major interstate pipelines' contracts studied there, a range which exceeds 100 percent among the pipelines' average gas costs. All pipelines, consequently, do not have comparable shares of permanently price controlled gas to use as a cushion, either on a percentage or volumetric basis. This cushion problem must be dealt with to avoid market chaos. S. 615 has a good chance of doing this successfully.

Tables 2 and 3, attached hereto, show the relative projections of volume and the relative price of old gas, new gas, and high cost gas purchased in the field by the interstate pipelines examined by EIA as of mid-1982. 32/

In addition, Table 4, which could not be prepared in time to be included in PEG's December testimony, illustrates the findings of EIA that the change in relative volumes of the categories of gas were the major cause of the increase in average gas price between 1981 and 1982. 33/ This conclusion was confirmed by the General Accounting Office. 34/ Price increases for old gas and new gas went up only 4 percent, but, because of the shift in volumes, the average price went up 17 percent. 35/

"Regulation" by Contract and Competition

Thus, the pressure is on the pipelines, both interstate and intrastate, and on the producers to negotiate and renegotiate. If they do, they live by their contracts. 36/ No more will Big Brother stand by to bail out one party or the other or to help one side or the other to negotiate, and this time there will be no "cushion" of permanent, super cheap, price controlled gas to subsidize unrealistic prices or terms in new or renegotiated contracts. And if contracts--both high and low--are not renegotiated, then either side can terminate any contract, 37/ so no one is stuck with a contract he can't live with. Come January, 1986, any party to a contract, existing or new or renegotiated, must live with it. 38/

And all the while, the customers of the pipelines--interstate and intrastate--are not at the mercy of the decisions made by their suppliers. Their remedy is direct. They may go into the field and make their own purchases. This is the greatest discipline to the pipelines, far more flexible and effective than additional federal regulation.

It will indeed be interesting to see whether witnesses will come before this Committee to ask that the privileges extended to their interests be adopted and the corresponding rights extended to the opposing interests be deleted. It is a real test of sincerity and good faith.

There are or may be technical drafting errors or perceived errors in the bill, and perhaps even better ways of reaching the same objectives, but we believe our time is better spent on the policy issues at this hearing.

Other Pending Legislation

We were also called upon to comment on certain other legislation pending before this Committee.

S. 689. This bill appears to extend federal regulation of wellhead sales of natural gas forever, through federal regulation of contract terms, 39/ and at prices lower than the NGPA ceiling prices. 40/ In addition, some contracts are subjected to the mandatory risk of renegotiation every thirty days. 41/ There apparently would be no stability in one set of contracts. Another set would be frozen in prices forever. The instability in this design should be a cause of concern for all. On the one hand, the cushion of cheap price controlled gas would be enhanced, thus continuing the present problem which results in bidding prices well above a market-clearing level because of the ability to average in the cheap price controlled gas. Yet, as soon as the contract for new supply is signed, the purchaser can exercise his statutory market-out on thirty days notice, and the seller has only the thirty days to find another purchaser. Even if he does, he must give a right of first refusal. 42/ Even if he survives this, the purchaser is only required to use "best efforts" to give the seller access to another purchaser. 43/ Thus, if the seller cannot do all of this in thirty days, he must accept the new price demanded by the purchaser. Then the purchaser can demand further reduction in thirty days. Then another, and another, and another.

Of course, if supplies get tight, it will be the seller who demands a new price every thirty days, if he wishes.

This does not appear to be a workable or a desirable system.

There is also an exception. Apparently some contracts will not be subjected to this treatment. 44/ It is difficult to understand why. No real reason is given.

S. 60, S. 239, S. 291, S. 292, S. 293. These bills are the same or similar to bills first introduced into the 97th Congress. They would impose various contract "fixes" and/or price freeze requirements. PEG offered comments on these proposals in testimony before this Committee in December, 1982. 45/ Our view has not changed. We continue to oppose piecemeal solutions involving additional federal controls. Therefore, I ask that our December testimony be incorporated by reference into my testimony today.

Conclusion

A solution to the nation's pressing natural gas problem must be achieved. The objective should be to bring the average price of gas at the wellhead to a market clearing level and to eliminate all "cushions" and preferences caused by federal controls. To this end, we believe S. 615 merits favorable consideration by this Committee.

Footnotes

1/ S. 615, § 201 (new or amended contracts decontrolled; all other natural gas decontrolled by 1/1/86). All statutory section references are to S. 615 unless otherwise specified.

2/ Section 202 (abandonment); § 302(a) (right of first refusal).

3/ Section 202; § 302(a) (minimum duration, filing requirements).

4/ Section 303 adding new § 316 (unilateral rescission rights); see also § 315(a) (take-or-pay); § 304 (escalators capped).

5/ Section 101 (limitation on passthrough of purchased gas costs).

6/ Section 101 adding new § 603(b) (separate rate case procedure).

7/ Id.

8/ Compare Natural Gas Act, §§ 4-5, 15 U.S.C. §§ 717c-717d.

9/ Section 101 (limitation on passthrough of purchased gas costs).

10/ Section 301(a) (price cap).

11/ Section 315(a) (take-or-pay reduction).

12/ Section 301(a) adding new § 311(b) (cap on 107(c)(5) at maximum lawful price on date of enactment); § 201 adding new § 121(b) (cap on deregulated 107 gas at higher of contract price on date of enactment or cap price).

13/ Section 301(a) adding new § 111(a) (cap on § 102-106, 108, 109).

14/ NGPA §§ 107(b), 104(b)(2), 106(c) and 109(b)(2).

15/ Section 303 adding new § 316 (unilateral rescission rights).

16/ Section 202 (abandonment); § 302(a) (right of first refusal).

17/ Section 401 (authorization of certain interstate sales, transportation and assignments); § 402 (access to interstate supply sources); § 403 (contract carrier authorization).

18/ *Id*.

19/ *Id*.

20/ Section 403 (contract carrier authorization).

21/ Section 315(a) (take-or-pay).

22/ Section 101 adding new § 603(f) (no cost recovery for affiliate or pipeline production gas unless volumes thereof reduced to same percentage of takes of cheaper gas).

23/ *Id*.

24/ Section 301(a) (price caps).

25/ Section 303 adding new § 316 (unilateral rescission rights).

26/ Section 401 (authorization of certain intrastate sales, transportation and assignments); § 402 (access to interstate supply sources); § 403 (contract carrier authorization).

27/ *Compare*, *e.g.*, *Cost and Quality of Fuels for Electric Utility Plants* 37 and Table 33 (November 1981) *with* 30 and Appendix I (April 1979 containing data for November 1978). EIA collects fuel cost data from electric utilities throughout the U.S. and publishes these data broken down by state and census region on a monthly basis. November, 1978 data was chosen as a basis for comparison with more recent data because the NGPA had not taken effect before that date. Comparison of the data will show a greatly increased disparity in burner tip gas prices among states and regions since the NGPA took effect.

28/ Testimony of John Johnson before the Subcommittee on Fossil and Synthetic Fuels, Committee on Energy and Commerce, U.S. House of Representatives (July 30, 1982).

29/ Testimony of Gordon Gooch before the Committee on Energy and Natural Resources, U.S. Senate (March 23, 1982).

30/ American Gas Association (AGA), "A Statistical Analysis of Bidding Trends for Decontrolled Natural Gas Under the NGPA," (March 19, 1982).

31/ EIA, The Current State of the Natural Gas Market: An Analysis of the Natural Gas Policy Act and Several Alternatives, Part I, Table 19, p. 66 (December 1981).

32/ *See*, Energy Information Administration, "An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases," Vol. 3, (September 1982) [hereafter EIA Report].

33/ Id. Table ES1 p. viii.

34/ General Accounting Office, "Natural Gas Prices: A Preliminary Analysis," GAO/RCED-83-76, p. 11 (1982).

35/ EIA Report, p. 37.

36/ Section 201 (new or amended contracts decontrolled).

37/ Section 303 adding new § 316 (unilateral rescission rights).

38/ Id.

39/ See, Highlights of "Natural Gas Policy Act Amendments of 1983," 129 Cong. Rec. S2138 (daily ed. March 3, 1983).

40/ The bill would repeal a number of actions taken by FERC and the courts in interpreting the NGPA, serving in effect to lower NGPA ceiling prices. For example, § 201(1) of S. 689 would effectively decrease prices by requiring in most cases the use of the "wet method" to measure the Btu content of gas. This would understate the actual Btu content of gas by about 1.74 percent. See Order No. 93-A, FERC Docket No. RM80-33 at 22 (mimeo) (issued April 24, 1981). Section 202(1) of S. 689 acts to reduce maximum lawful prices by preventing area rate clauses from triggering NGPA prices, contrary to the specific interpretation of the NGPA by the Fifth Circuit in Pennzoil Company v. FERC, 645 F.2d 360 (5th Cir. 1981). Section 202(2) would reduce prices by repealing the inflation adjustment factor provided under the NGPA and by severely curtailing recovery by producers of certain "production-related" costs as allowed under FERC's recently issued Order Nos. 94-A and B, FERC Docket Nos. RM80-47-002 and RM80-47-003 (mimeo) (issued January 24, 1983).

41/ Section 203(2) adding new § 316(b)(1) (exercise of market-out by producer).

42/ Section 203(2) adding new § 316(b)(2) (exercise of market-out by seller).

43/ Section 203(2) adding new § 316(b)(3) (transportation and service and rates for seller exercising market-out).

44/ Section 203(2) adding new § 316(b) (intrastate contracts and contracts not deregulated under the NGPA have no market-out clause imposed by the bill. See, Section-by-Section Analysis of Natural Gas Policy Act Amendments of 1983, accompanying S. 689. 129 Cong. Rec. S2139).

45/ Testimony of Richard C. Perry before the Committee on Energy and Natural Resources, U.S. Senate (December 13, 1982).

TABLE 1

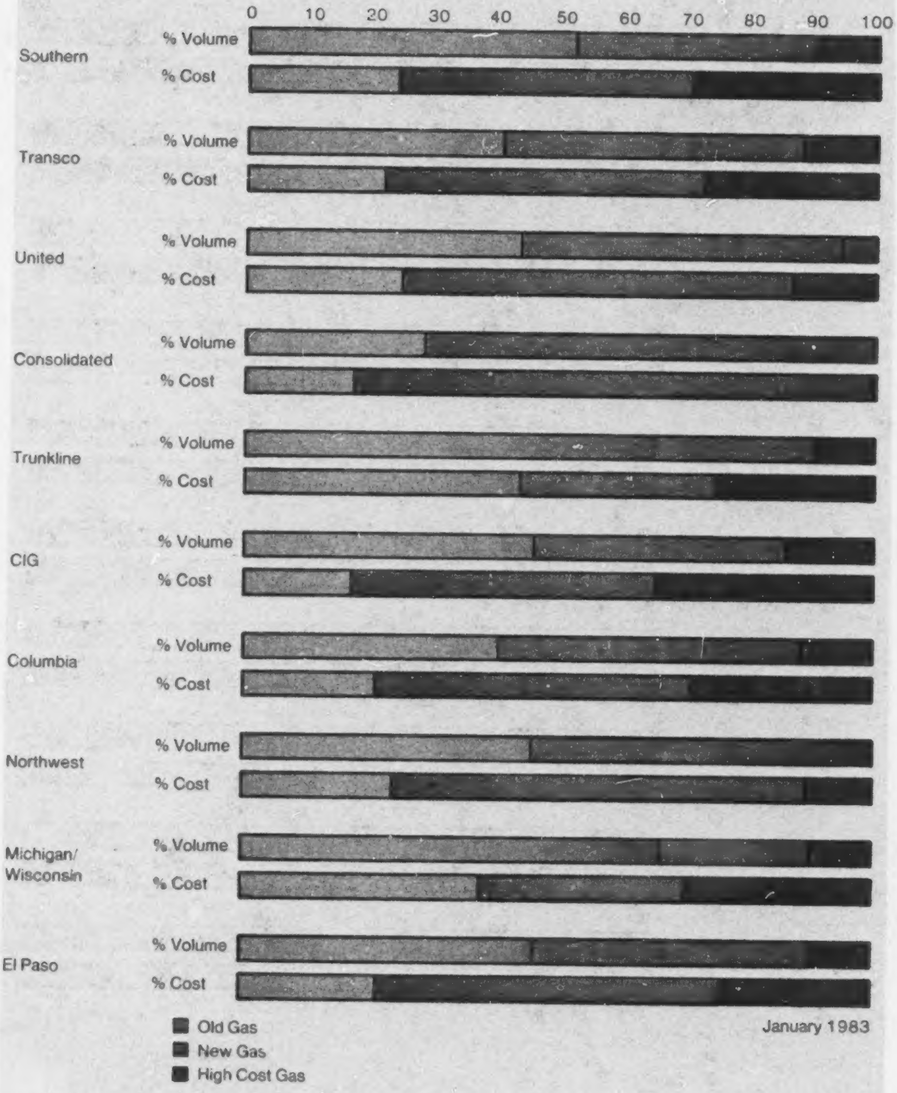
ADMINISTRATION'S FEBRUARY 28, 1983 GAS PROPOSAL: BALANCES

I. DEREGULATION	II. CONTRACTS	III. ADDITIONAL CONSUMER FACTORS
A. New and renegotiated wellhead gas contracts are free of all federal controls; price, contract terms, federal selection of purchasers. (See I.B; II.A; III.A,C).	A. Escalator and area rate clauses in existing contracts track lower of "market price" or applicable NGPA price, if any, until 1/1/86. ("Market price" is I.A.).	A. Cap on automatic rate increases for purchased gas supply through 1/1/86; FERC to entertain special rate cases. (See II.A,B,C,D; III.B.).
B. All NGA and NGPA contract and purchaser selection controls on producer contracts ending by 1/1/85, subject to II, and all price controls ending on 1/1/86.	B. Unilateral rescission rights in existing contracts for producer or purchaser on 1/1/85 with transportation rights at incentive rate.	B. Limitation on pipeline takes of its own gas and gas purchased from an affiliated producer. (See III.A; II.C.).
C. All barriers to competition for gas supply based on state or Federal boundaries. (See II.B,C; III.C.).	C. 70% cap on discretionary take-or-pay at option of purchaser until 1/1/86, with resulting option-out for seller for shut in volumes with transportation rights at incentive rate.	C. Opportunity for any purchaser to secure transportation of gas through an unwilling interstate pipeline by FERC order at incentive rate. (See I.A,B,C,D; II.B,C.).
D. End Fuel Use Act, incremental pricing and power to reimpose controls without further legislation.	D. 107 gas price capped until 1/1/86. No increase in ceiling price for "old" gas mandated.	

SOURCE: BAKER & BOTTS

TABLE 2

Relative Percentage of Volume and Price
Pipeline Contract Patterns
(Mid-1982 PGA Projections)

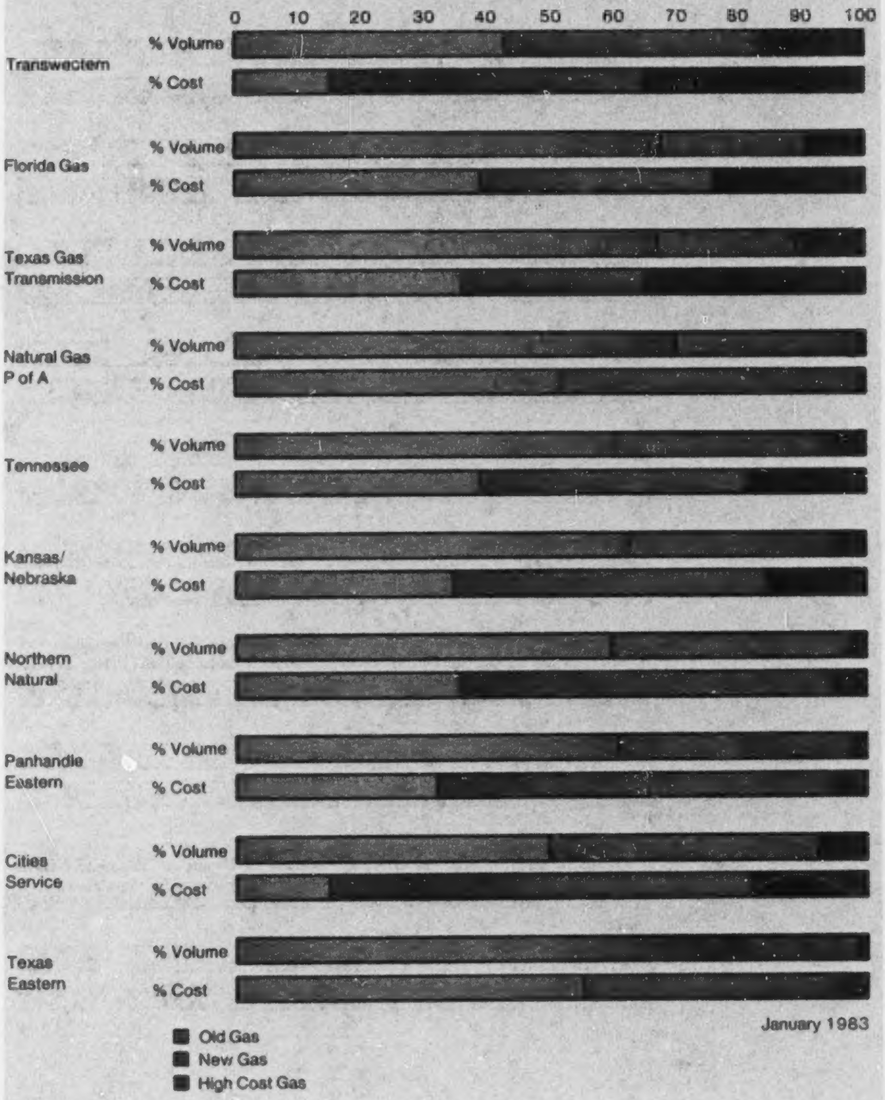


January 1983

SOURCE EIA An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases Sept. 1982

TABLE 3

Relative Percentage of Volume and Price Pipeline Contract Patterns (Cont'd) (Mid-1982 PGA Projections)

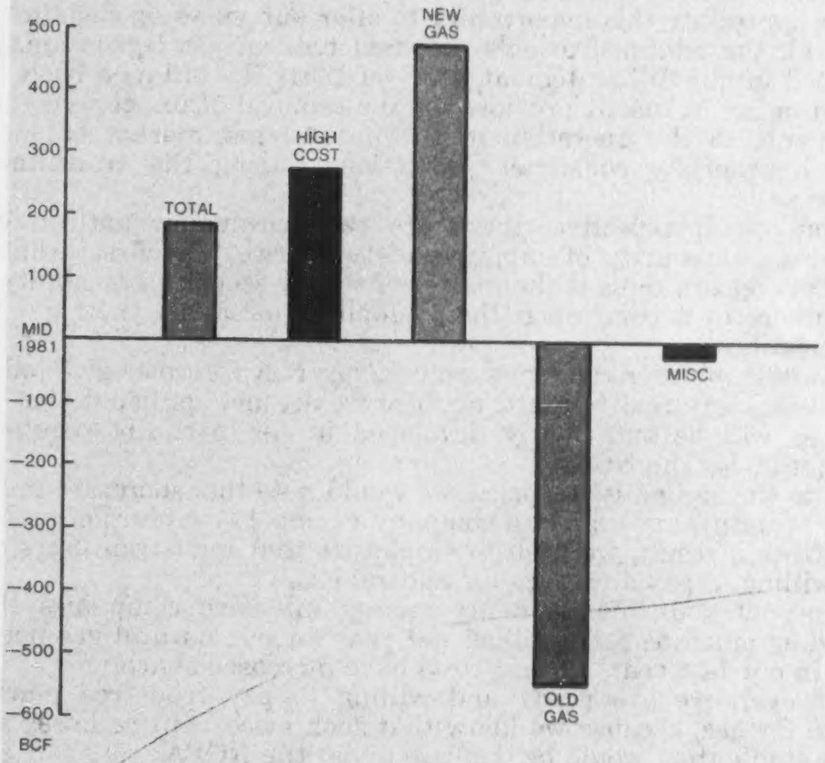


January 1983

SOURCE: EIA An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases Sept. 1982

TABLE 4

TOTAL CHANGE IN PROJECTED VOLUMES MID 81—MID 82 OF PURCHASES FROM PRODUCERS BY MAJOR INTERSTATE NATURAL GAS PIPELINES



SOURCE: EIA TABLE ES1 DOE/EIA 0357 SEPT. 1982

BAKER & BOTTS
DECEMBER 1982

Senator **Murkowski**. We will move on to Mr. Elam. Welcome to the committee, Mr. Elam. Please proceed.

STATEMENT OF JACK ELAM, PROCESS GAS CONSUMERS GROUP

Mr. **Elam**. Thank you, Mr. Chairman.

The Process Gas Consumers Group is an organization of industrial consumers of natural gas in processes in which alternate nongaseous fuels cannot reasonably or technically be utilized.

In other words, Mr. Chairman, we are left on the line with the residential consumers after the CIBO group pulls out, and goes to oil.

We appreciate this opportunity to offer our views on Senate bill No. 615, the administration's proposed natural gas legislation. As detailed in our full statement, PGC supports the bill as a basis for compromise, in that it provides for the removal of unnecessary impediments to the operation of the natural gas market balanced with appropriate consumer protections during the transitional period.

From our perspective, there are two paramount natural gas issues. One, security of supply; and two, price. The first primary issue of concern to us is the matter of supply security, the ability of consumers to depend upon their suppliers to satisfy their gas requirements.

However, neither random surpluses nor rosy forecasts give industrial users any real comfort, because we are not confident that resources will be sufficiently developed in the partially regulated market under the NGPA.

As to the second issue, price, we would note that increases in the price of natural gas affect a company's competitive position and its profit. As a result, we wish to emphasize that industrial users are not willing to pay any price for natural gas.

Many of your members are energy intensive companies that spend as much as $200 million per year for our natural gas needs. And in our last year, our gas costs have increased sharply.

However, we are ready and willing to pay true free market prices for gas, because we know that such prices will be lower and more stable than would be the case under the NGPA.

Because of these concerns, we respectfully urge this committee to give important priority to the enactment of legislation such as S. 615, which would deal boldly and comprehensively with the problems now facing the gas industry and gas consumers.

We also urge the committee to decline to pursue the kind of quick-fix proposals that have recently been advanced in Congress.

When we appeared before this committee in December, we outlined a proposed program for comprehensive gas legislation. And I would like to discuss the six essential elements of that program.

No. 1, removal of wellhead price controls from all natural gas. PGC believes that deregulation of all gas will produce the most equitable and efficient solution to the problems confronting the Nation's gas markets.

The retention of controls on some or all categories of gas will inevitably yield market distortions analogous to those experienced under the Natural Gas Act and the NGPA.

Senate bill No. 615 couples complete deregulation of wellhead prices with a mechanism for dealing with the contract problem, which was the second element of our program.

Extreme contract terms induced by the NGPA scheme of partial regulation will have to be modified if the transition to deregulation is to be smooth and successful. PGC favors voluntary renegotiation of existing contracts through use of market-out rights.

PGC prefers an immediate market-out approach, rather than the cap delayed market-out option of S. 615. With market-out clauses in all contracts not otherwise renegotiated under S. 615, parties to wellhead gas sales contracts will be able to insist on renegotiating their contracts.

Consequently, any party with an unfavorable contract relative to prevailing market conditions will be able to bring its contract in line with the current market.

No. 3, S. 615 repeals the incremental pricing program, NGPA title II, and the Power Plant and the Industrial Fuel Use Act. We would only suggest that repeal of these measures should be accomplished in such a way that their effects cease immediately.

No. 4, the bill provides for the mandatory filing with FERC of all new or renegotiated natural gas purchase contracts between producers and buyers.

No. 5, it provides for expanded access to natural gas supplies by all pipelines, distribution companies, and end users.

Section 403 of the bill will facilitate the acquisition of self-help supplies of natural gas by industrial users. We believe that the proposed statutory provisions would help overcome past obstacles to self-help.

An essential element of this remedy, and one which would eliminate the need for FERC mandatory rules or orders under section 403, would be statutory provisions which encourage voluntary pipeline participation by allowing pipelines to keep a greater portion of transportation revenues.

Finally, No. 6, the bill does not include any so-called windfall profits tax on natural gas. The concept of taxing away so-called windfall profits is fundamentally repugnant to our membership and to the free enterprise system.

A note of caution must be raised about the workability of the provisions of section 101 of S. 615. It adds a new section 603 to the NGPA, that places a limitation on the passthrough of certain gas purchase costs. PGC has been most active in an effort to urge the FERC to utilize its existing authority more vigorously to review gas purchasing practices of interstate pipelines.

However, any mechanism involving a limitation on costs passthrough must on the one hand allow recovery by pipelines of appropriate costs, and on the other hand retain effective protection for gas consumers.

We are concerned that the provisions of section 603 do not strike a proper balance between these two goals. The ability of pipelines to pass through reasonable costs is so inhibited, that pipelines may be discouraged from participating in the renegotiation process that is the heart of S. 615.

We offer the following suggestions. First, at a minimum, the FERC's authority to allow pipelines to collect charges subject to refund should be retained. Second, the special proceeding created by section 603(b) to consider questions relating to recovery of additional gas purchase costs should be deleted.

We are fearful that such an additional layer of procedure will create administration difficulties for the FERC, and will result in substantial delay in the resolution of pipeline gas purchasing issues.

Instead, the existing PGA process should be utilized to consider questions of pipeline cost recovery above the allowable rate established under section 603. And we have provided specific suggestions for appropriate mechanisms in our full statement.

Mr. Chairman, in the interests of time, we have discussed other legislative proposals, but I think I stand on those proposals. For example, the freeze is well known.

I would like to add before closing that also in our full statement, we take up the question of contracts for imported gas. And we propose a solution generally along the lines of the process contained in S. 615. I would like to refer you to the full statement for our discussion of imported gas.

Senator MURKOWSKI. The full statement will be included in the record.

Mr. ELAM. Yes, sir.

In concluding, we applaud the administration's initiative in submitting natural gas legislation. While we have indicated some concerns about certain specific provisions of the bill, we strongly support the goals of S. 615 with its complete deregulation of all wellhead prices for natural gas by a date certain combined with a market-oriented resolution to the NGPA's contract problem, and prompt elimination of demand restraints.

We appreciate this opportunity to present our views. We would be pleased to answer any questions.

Senator MURKOWSKI. Thank you, very much, Mr. Elam.

[The prepared statement of Mr. Elam follows:]

TESTIMONY OF

JACK ELAM

BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

STATEMENT OF
THE PROCESS GAS CONSUMERS GROUP [*]

The Process Gas Consumers Group (PGC) is an organization of thirteen large industrial consumers of natural gas organized to promote the development and adoption of coordinated, rational, and consistent federal and state policies with respect to gas use. Representing many of the Nation's basic industries, our member companies own and operate hundreds of plants in virtually every state and purchase natural gas directly or indirectly from both interstate and intrastate pipelines, with most of our facilities on the interstate system.

PGC appreciates this opportunity to offer its views on S. 615, the Administration's proposed natural gas legislation. As detailed in the following comments, PGC supports the bill as a basis for a compromise in that it provides for the removal of unnecessary impediments to the operation of the natural gas market, balanced with appropriate consumer protections during the transitional period.

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[*] This statement is also endorsed by the Association of Businesses Advocating Tariff Equity (ABATE), an organization of twenty-seven industrial companies located in the State of Michigan. ABATE's purpose is to advocate the establishment of utility and energy rates, terms, and conditions of service and other tariffs or contracts governing utility service which are just and reasonable, non-discriminatory, and cost-based. ABATE's members all consume natural gas through interstate pipelines and local distribution companies serving Michigan.

I. STATEMENT OF POSITION

While the range of uses in which PGC members use natural gas is quite broad, PGC's views with respect to natural gas issues reflect primarily its members' use of natural gas in industrial processes in which alternate, non-gaseous fuels cannot reasonably or technically be utilized. From this perspective, as well as from the perspective of consumers who use gas in other industrial applications, there are two paramount natural gas issues: (1) price and (2) security of supply.

As to the first issue, industrial users are no more anxious than anyone else to see their gas bills increase. Natural gas, as with the other inputs into the manufacturing process, presents costs which must be recovered by companies in the prices charged for their products. Increases in the price of natural gas raise the cost which must be recovered and thus affect a company's competitive position and its profit. As a result, PGC wishes to emphasize that industrial users are not willing to pay any price for natural gas. Many of our members are extremely energy intensive companies that spend as much as $200 million per year for our natural gas needs, and we have seen a 20-30% increase in our gas bills in the past year. In an economic climate which has not been particularly beneficial to manufacturing activity, 30% of $200 million dollars is very significant.

We do not, however, believe that gas decontrol will mean higher bills for gas consumers. We are ready and willing to pay true free-market prices for gas because we anticipate that such prices will be lower -- and more stable -- than would be the case under the Natural Gas Policy Act (NGPA). Perhaps even more important, we also believe that such free-market prices will be lower than the costs that we (and the Nation) will incur if energy policy regresses to the reimposition of price controls with the attendant risks of renewed supply shortages and resultant economic and social dislocations. Thus, PGC believes that wellhead price controls must be removed if supply and demand in the gas market are ever to be brought into balance and if the price for gas is ever to reflect that balance. We must emphasize, however, that, while we are willing to pay free-market prices for gas, we are strongly opposed to (1) paying prices higher than those which would be commanded in a truly free market, and (2) paying a disproportionate share of higher gas costs so that other gas consumers can be subsidized, such as through so-called incremental or marginal cost-based pricing schemes. As consumers, we cannot tolerate the impact of such artificially high gas prices on our businesses.

The second primary issue of concern to us is the matter of supply security -- the ability of consumers to depend upon their suppliers to satisfy their gas requirements.

PGC's concern with supply security may seem to some to be unwarranted, particularly during this period when (1) interstate pipelines appear to be scrambling to find ways to dispose of their excess gas supplies, and (2) we are repeatedly told that the United States' conventional gas resource base remains sufficient to meet current levels of demand for several decades. However, neither current supply surpluses nor these gas resource forecasts give industrial users any significant comfort because we are not confident that those resources will be efficiently elicited in the partially-regulated "market" under the NGPA. That "market" is characterized by wildly disparate prices -- some far below "market clearing" and others absurdly above it. Some pipelines are already experiencing real industrial load losses as they purchase expensive supplies under strict take-or-pay provisions and turn away cheaper supplies. High-cost supplies are being produced before lower-cost supplies, further depressing demand, distorting the signals sent back to producers as to future gas needs, and setting the stage for potential future shortages. Indeed, drilling has been sharply reduced below 1981 levels.

Thus, so long as substantial volumes of natural gas remain subject to distorting price controls -- which insulate gas prices from the realities of the market and inexorably push some prices higher while others remain artificially low -- industrial users are not comforted by large estimates of conventional domestic gas resources when those estimates assume production at reasonably stable, free market prices. PGC is confident that the free market -- not "quick fix" tinkerings with the current scheme -- will work to produce those resources and bring supply and demand into balance. But, until such a free market exists, PGC has no such confidence in long-term gas supply reliability. Bubbles form and burst quickly. If we have learned anything in the recent past under regulation, it is that we do a poor job of predicting future gas supplies.

The same observations may be made with respect to the gas surpluses currently being experienced in some parts of the country. PGC believes that such surpluses are in part the product of the unstable conditions which have been fostered by the NGPA. The perpetuation of such conditions is no basis upon which to make national energy policy, and such conditions are inimical to restoring industrial user confidence in the gas market's ability to meet their long-term needs.

For the reasons discussed below, therefore, PGC respectfully urges this Committee to decline to pursue the kind of myopic, "quick fix" proposals which have recently been advanced in Congress. Instead, this Committee should give important priority to the enactment of legislation such as S. 615 which will deal boldly and comprehensively with the problems now facing the gas industry and gas consumers. Now is the time for Congress to take steps to get us out of the morass created by the NGPA; but Congress must resist the temptation to adopt superficial measures which will only sink us deeper into that morass.

II. ESSENTIAL PROVISIONS FOR ANY GAS LEGISLATION

The NGPA did not create a free gas market, and the Nation's sad experience under the NGPA teaches us nothing about how free markets operate. At best, the NGPA has taught us that a part-regulated/part-deregulated "market" severely distorts the exploration and development, distribution, and price of natural gas; causes rapidly rising wholesale and retail prices without inducing corresponding increases in gas supplies; produces surpluses in some locations and shortages in others; and contributes to the demand for energy imports, such as exorbitantly priced LNG from Algeria.

The difficulties in which we currently find ourselves is the result of gas producers, pipelines, distributors, and consumers all attempting to pursue their legitimate self-interests and fulfill their obligations in a hopelessly-confused pseudo-market. While perhaps no one could have predicted in 1978 that things would go as far awry as they have, Congress' failure to deregulate natural gas at that time could reasonably have been expected to deprive the gas market of the flexibility needed to respond to dynamic and unforeseen changes in the economy, oil prices, and other factors bearing on gas supply and demand.

PGC believes that it is time to give the market a chance to work. Therefore, in order to increase the stability of the gas industry, enhance service to gas users, hold down prices for all consumers, avoid future supply shortages, and eliminate the market distortions caused by the NGPA, PGC advocates the adoption of comprehensive gas legislation containing the following key provisions:

(1) Remove wellhead price controls from all natural gas as of January 1, 1985.

(2) Provide a market-oriented resolution of the much-discussed "contract problem" through insertion of market-out rights in all existing contracts, including contracts for imported gas.

(3) Repeal the incremental pricing program (NGPA Title II) and the Powerplant and Industrial Fuel Use Act.

(4) Provide for the mandatory filing with the FERC of all natural gas purchase contracts between producers and pipelines and make them available for public inspection.

(5) Provide expanded access to natural gas supplies by all pipelines, distribution companies, and end-users.

(6) Reject proposals to include any so-called "windfall profits tax" on natural gas.

PGC approaches the current natural gas crisis as industrial gas consumers who pay a substantial portion of the bills. We also approach the situation as manufacturers who need assurances that natural gas -- as well as all other forms of energy -- will be available for us to purchase in the quantities we need and at prices which are reasonable. Without that kind of long-term energy market stability, we cannot rationally plan the investments we need to make to get this country's economy solidly back on its feet for good. Unfortunately, price regulation at the wellhead is anathema to stable prices and supplies. The Natural Gas Act, as applied by the Supreme Court to gas pricing at the wellhead, produced shortages, and the NGPA is producing the current crisis.

Consequently, PGC favors a comprehensive approach of the type proposed in S. 615, and opposes adoption of myopic bills which would simply tinker with the NGPA's misguided scheme of price controls in the hopes of extending their operation. Now is the time to stop trying to run the marketplace from Washington and to call an end to all wellhead price regulation once and for all. Price regulation didn't work for oil; it didn't work for the economy as a whole; and it isn't working for natural gas.

III. S. 615

S. 615 offers a basis for a reasonable compromise among the widely divergent views of those interested in gas issues. As such, PGC hopes that the Administration's proposed bill will provide a rallying point for comprehensively dealing with the serious problems existing under the NGPA. S. 615

should serve both the goal of providing a workable mechanism for transition to the free market and the goal of protecting consumers. The proposal resembles PGC's proposed program in the following respects:

1. It would provide for the deregulation of all gas by a date certain. S. 615 accomplishes this by January 1, 1986, as compared to PGC's preferred date of January 1, 1985.
2. It would emphasize renegotiation of contracts and provide market-out rights for either party if a contract were not renegotiated. (S.615 would delay such market out rights until January 1, 1985, as compared to allowing such market-outs immediately as in the PGC proposal.)
3. It provides for immediate repeal of incremental pricing and the Fuel Use Act.
4. It provides for equal access for buyers of natural gas.
5. It apparently rejects a windfall profits tax by providing in lieu thereof protection of consumers through a limitation on automatic pass-through of increased gas costs above inflation. Adoption of the limited pass-through mechanism essentially reflects in statutory form the theories of authority over pipeline purchase practices that PGC has been advocating before the FERC over the last two years.

Set forth below is a more detailed discussion of these points:

(1) Removal of wellhead price controls from all natural gas. PGC believes that deregulation of all gas, in contrast with NGPA-type deregulation of only some gas or the reim-

position of price controls will produce the most equitable and economically efficient solution to the problems confronting the Nation's gas markets. Any effort to retain controls on some or all categories of supplies will inevitably yield market distortions analogous to those experienced under the Natural Gas Act and the NGPA.

(2) S. 615 accompanies complete deregulation of wellhead prices with a mechanism for dealing with the "contract problem." PGC recognizes that extreme contract terms induced by the NGPA's scheme of partial regulation will have to be modified if the transition to deregulation is to be effectuated smoothly and successfully. To effect the needed modification, PGC favors the type of approach that would encourage producers and purchasers voluntarily to renegotiate their existing contracts and would facilitate such renegotiation through establishment of market-out rights.

PGC prefers an immediate market-out approach, as compared with S. 615's gas cap/delayed market-out option. Our preference stems from the view that, in contrast to caps or other forms of wellhead price controls, the immediate market-out approach is straightforward, workable, and, therefore, easier to implement without extensive regulatory (and judicial) oversight. Thus, while we are pleased that S. 615 recognizes the value of the market-out concept, we are concerned that the specific gas cap provided in S. 615 may be an improper surrogate for market prices. If the cap chosen is not truly reflective of the market, it may result in prices so artificially low as to impede or even reverse progress toward wellhead price deregulation and create disincentives for the renegotiation that is an essential element of the process contemplated by S. 615.

Renegotiation by the parties will produce better results than will efforts to structure gas purchase and sale arrangements by fiat from Washington, D.C. And, given the substantial surplus of deliverable supplies that now exists, consumers should be the principal beneficiaries of renegotiation at this time.

Both PGC's and S. 615's contract solutions are similar to the market-out clause mechanism which some pipelines and producers have been including in their contracts for deregulated gas in recent years. Those clauses recognize that, while parties desire long term contracts, they must be free to adopt price and non-price terms to meet changing market conditions over time. With the insertion of these clauses now in all contracts not otherwise renegotiated under S. 615, all parties to wellhead and imported gas sales contracts will be able to insist on renegotiating their contracts. Consequently, any party with an unfavorable contract relative to prevailing market conditions would be able to bring its contract in line with the current market. Mutual self-interest should assure that this is done and should prevent any party from overreaching during the difficult transition to full decontrol. Thus, it would be unlikely that Congress would have to get back into the picture. At the point of full decontrol, the market should be well balanced, and buyers and sellers will likely voluntarily include market-out clauses in their contracts as a routine matter.

PGC also strongly urges that market-out rights not be limited to contracts for the first sale of domestic natural gas. Buyers and sellers under contracts for expensive overland imported gas or imported liquefied natural gas (LNG) should also have market-out rights. Such rights should be availably immediately, and they should apply to existing import contracts and to pending and future import applications.

Contracts for imported gas are as much a part of the "contract problem" as domestic gas contracts. Like high Section 107 contract prices, high imported gas prices are possible only because they are subsidized by the controlled prices of "old" domestic gas. The same distorted Natural Gas Act and NGPA market environment that led pipelines to accept stringent take-or-pay terms and one-way price escalators in domestic contracts also led pipelines to accept similar provisions in contracts with foreign producers. It is, therefore, entirely appropriate -- and essential -- that mechanisms adopted to solve the "contract problem" be made available to solve the aspects of that problem created by gas imports.

Specifically, U.S. purchasers of gas from Algeria, Mexico, Canada, and other sources should have the same market-out rights afforded to "first sale" purchasers. S. 615 should provide that the exercise of such rights will not give rise to any liability on the part of the U.S. purchaser and that no contract or enforcement claim by the foreign producer will be cognizable in any U.S. court.

In PGC's view, failure by Congress to solve the imported gas contract problem will permit foreign producers to continue to reap the benefits of the remaining domestic gas "cushion", and will increase the risk that important industrial gas consumers will be priced out of the market, to the detriment of industrial consumers, the gas industry, and all gas consumers.

Finally with respect to the contract solution, PGC would also recommend that S. 615 be modified to give pipelines a right of first refusal in cases in which a producer opts out in favor of another buyer. However, to protect independent producers from potential bad faith bargaining tactics, pipelines should not be given a right of first refusal in cases in which the pipeline was the one to opt out of a contract. This would be consistent with the existing provisions of S. 615 which obligate pipelines to provide transportation services at "just and reasonable" rates approved by the FERC in the event a producer sells gas to a third party; these provisions serve to protect independent producers from abuses of pipelines' monopsony power.

(3) S. 615 repeals the incremental pricing program (NGPA Title II) and the Powerplant and Industrial Fuel Use Act. Repeal of these measures should be accomplished in such a way that their effects cease immediately. To accomplish this with respect to incremental pricing, S. 615 should be modified so that consumers are not charged for "incremental" costs incurred by pipelines and distribution companies but not passed through by the date of enactment. We will be pleased to provide the Committee with language to accomplish this.

(4) S. 615 provides for the mandatory filing with the FERC of all new or renegotiated natural gas purchase contracts between producers and buyers.

(5) S. 615 provides for expanded access to natural gas supplies by all pipelines, distribution companies, and end-users. Section 403 of the bill would particularly facilitate the acquisition of self-help supplies of natural gas by industrial users.

PGC supports the basic thrust of Section 403. Industrials are not the only ones who benefit from self-help arrangements. Experience demonstrates that producers, pipelines, and distributors (as well as the consumers they serve) all benefit. Producers find new markets for their gas; pipelines receive increased revenues; pipeline customers and consumers enjoy reduced rates as a result of the crediting of a portion of the self-help transportation revenues to the transporting pipeline's cost of service; and distributors and users are given the opportunity to add cheaper or more reliable alternatives to their traditional pipeline sources. Unfortunately, some pipelines have either refused to transport self-help gas, or have agreed to do so only on terms which, as a practical matter, discourage industrials from pursuing self-help arrangements.

PGC believes that the proposed statutory provisions would help overcome past obstacles to self-help. An essential element of this remedy -- and one which would hopefully eliminate the need for FERC mandatory rules or orders under Section 403 -- would be statutory provisions which encourage voluntary pipeline participation by allowing pipelines to keep a greater portion of transportation revenues. For example, the provision of S. 615 which would allow a willing pipeline participant to keep at least 5 cents per MMBtu for each MMBtu transported might, by itself, be enough to convince some pipelines to transport industrial self help gas that they would not otherwise haul. This is certainly an improvement over the current policy of allowing a pipeline to keep only one cent/MMBtu of transportation revenues, with the remainder of such revenues being credited to the pipeline's cost of service.

(6) S. 615 does not include any so-called "windfall profits tax" on natural gas. The concept of taxing away so-

called "windfall" profits is fundamentally repugnant to PGC members. Regardless of when and how natural gas is decontrolled, natural gas producers should be permitted to charge and retain the full free-market price of such gas.

PGC does wish to raise a note of caution about the workability of the provisions of Section 101 of S. 615 which adds a new Section 603 to the NGPA, placing a limitation on the passthrough of certain gas purchase costs. PGC has been most active in the effort to urge the Federal Energy Regulatory Commission (FERC) to utilize its existing authorities under the Natural Gas Act and the Natural Gas Policy Act more vigorously to review the gas purchasing practices of interstate pipelines. As noted in our written answers to questions posed to us by this Committee subsequent to its December 1982 hearing, we have consistently urged FERC to consider certain purchase practices to be abusive and to deny automatic passthrough of gas costs resulting from such practices. Because of our position that the NGPA was never intended to remove the Commission's longstanding authority to protect consumers from such abusive purchasing practices, we are encouraged by the general approach contained in Section 603. Utilization of traditional mechanisms such as gas purchase cost review is far preferable to some combination of windfall profit tax and complex rebate schemes which attempt to return money to certain statutorily-defined favorite classes.

However, we would note that any mechanism involving a limitation on cost passthrough must, on the one hand, retain flexibility to allow recovery by pipelines of appropriate costs while, on the other hand, retaining effective protection for gas consumers. We are concerned that the current provisions of Section 603 do not strike a proper balance between those two goals because they may so inhibit the ability of pipelines to passthrough reasonable costs that there may be substantial disincentives for pipelines to participate in the renegotiation process that is the heart of S. 615. Thus, we would offer the following suggestions for modification of Section 603.

First, at a minimum, FERC's authority to allow pipelines to collect charges subject to refund should be retained. The second sentence of Section 603(b) would arbitrarily limit this longstanding authority of the Commission.

Beyond that modification, we would prefer that there not be created a new special proceeding of the nature created by Section 603(b) to consider questions relating to recovery of additional gas purchase costs. We are fearful that such an additional layer of procedure will create administrative difficulties for the FERC and will result in substantial delay in the resolution of pipeline gas purchasing issues, thereby creating additional disincentives for the pipelines to participate in the renegotiation process. As an alternative, we would propose that the existing PGA process be utilized to consider questions of pipeline recovery of costs above the allowable rate established under Section 603. This could be accomplished through formulation by FERC within 60 days after date of enactment of specific generic standards to be applied to pipeline requests to recover costs in excess of their allowable PGA rate. Such regulatory standards should be formulated in such a fashion as to permit the recovery of such additional gas costs to the extent those costs are needed to render adequate service at lowest reasonable rates to existing customers. This could allow, for example, pipelines with large cushions, who might otherwise be potentially disadvantaged by the inflexible provisions of Section 603, to replace their depleting Section 104 gas supplies with new gas, but, at the same time, not inhibit their participation in the renegotiation process.

If Congress insists that a special proceeding is necessary as an alternative to utilization of the normal PGA procedure, we would strongly urge that a truly expedited proceeding be established, requiring the Commission to complete its consideration of evidence and issue appropriate orders within strict deadlines.

IV. OTHER LEGISLATIVE PROPOSALS

A. A series of bills has been introduced providing for a temporary or permanent freeze on wellhead prices. For example, S. 60 (introduced by Senator Kassebaum) and S. 293 (introduced by Senator Eagleton) both provide generally for a two-year price freeze and two-year delay of the NGPA's scheduled deregulation of certain categories.

A freeze on wellhead prices would, at best, simply halt the inexorable price increases being experienced under the NGPA; it would not allow gas consumers to see any reduction in their gas bills. Moreover, any price relief which is experienced may likely be short-lived. This is due to the fact that freezing price ceilings at mid- to late-1982 levels would be an invitation, if not an order, for renewed gas shortages. It would severely undermine exploration for and development of new reserves and, at the same time, send a signal to users to increase consumption. With the elimination of incentives and the gradual erosion of price ceilings by inflation, these freeze provisions would send a message to producers that the government cannot be trusted to fulfill its commitment to deregulation and that permanent regulation might occur. As shortages develop, there would be greater demand not only for imported oil, but also for imported gas at unfrozen prices. Thus, any potential cost savings resulting from the freezing of domestic gas prices would be reaped by foreign producers, not by gas consumers -- just as was the case in the pre-NGPA era.

In addition, the rigidity of these price freeze proposals would deprive the gas market of all flexibility to meet changed circumstances until a new crisis forced Congress back into the picture -- creating the potential for a replay of 1978's sorry experience with gas legislation.

By returning to a fully price-controlled environment, the financial situation of all sectors of the gas industry would suffer as market volatility makes it substantially more difficult to plan exploration, purchasing, and marketing activities.

Today's gas market problems are due in large part to the fact that, in 1978, Congress did not go far enough, not because it went too far. The solution, therefore, to today's problems do not lie in regressing to the pre-NGPA price-controlled approach, but rather in fixing the flaws in the NGPA in order to permit the transition to a fully decontrolled market to be effected more smoothly and effectively.

B. Another general category of current legislative proposals includes those which reflect the belief that a Draconian solution to the "contract problem" is all that is needed to "fix" the NGPA. This category includes S. 689 (introduced by Senator Heinz) and S. 291 (introduced by Senator Danforth). These proposals range from outright blanket prohibitions against all take-or-pay clauses and indefinite price escalators to a broad expansion of the grounds upon which the FERC may block the passthrough of pipeline purchase costs and act to revise or annul contract terms. (Some of these bills also provide certain reporting requirements under which pipelines report to

FERC their progress in achieving the lowest possible weighted average gas acquisition cost.) */

Although PGC agrees that piplines' take-or-pay obligations are unreasonably high in many contracts negotiated under the NGPA, we also recognize that take-or-pay clauses provide producers (particularly independents) with some income stability and the cash flow needed to finance new exploration and development. A blanket prohibition against take-or-pay clauses would, therefore, cause an immediate reduction in exploration and development and then eventual shortages. Moreover, such a prohibition would be yet another boon for foreign gas producers who may be exempt under it.

An outright ban on all take-or-pay clauses would also result in rising gas prices as producers lose cash flow stability and markets begin to tighten up. In exchange for their added risks, producers would demand higher sales prices to

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*/ S. 60 combines its proposed "contract problem" solutions with a proposed price freeze. This combination of proposals makes it even less desirable than bills which propose simply one or the other. S. 60 would devastate gas exploration and development and inevitably lead to supply curtailments to gas consumers. Faced with frozen prices, plus a loss of take-or-pay commitments (and the appearance that Congress will keep extending controls), domestic producers would slash their exploration and development budgets. Significant gas curtailments could begin quickly in some areas of the country and adversely affect meaningful economic recovery. Again, Canadian, Mexican, and Algerian producers would be in the best position to take advantage of such shortages by raising their prices while U.S. producers are prohibited from raising theirs and eliciting greater domestic supplies.

justify their investment in exploration and development, and the tighter markets would enforce those demands for higher prices. (If a freeze proposal were also enacted, the higher prices would not be avoided; they would simply be collected by foreign gas sellers.) As a result, gas consumers would be dealt a double blow: forced to pay both the higher charges commanded by foreign or domestic producers plus a larger share of the pipelines' and distributors' fixed costs as their markets shrink.

Further, apart from the enormous administrative burden which would result from the proposed exemption provisions, pipelines which are totally freed from take-or-pay obligations would be placed in a strong position to favor their own gas production affiliates at the expense of potentially lower-priced gas from independent producers.

Finally, although PGC certainly supports measures to encourage pipelines to purchase first the cheapest gas available, the rigid "cheapest-first" rule being proposed would be extremely complicated and expensive to implement. It would require many pipelines to adopt complex new operating procedures and to install expensive metering equipment -- all of which would be paid for through higher rates to consumers. Moreover, it would inevitably lead to extensive litigation which, apart from the costs which it too would impose on ratepayers, would create the kind of uncertainty which seriously undercuts the ability of the gas market to develop and deliver secure long-term supplies.

With respect to proposals to expand the terms of NGPA §601(c)(2), PGC believes that much of the intent of such bills (e.g., S. 239) is certainly laudable. Customer resistance to high gas prices is an essential element in bringing gas supply and demand into balance and keeping them there. Since interstate pipelines and local gas utilities are still subject to regulation (and will remain so even after full wellhead price decontrol), the ability of gas consumers to challenge excessive gas acquisition costs in regulatory forums is essential if pipeline purchasing practices are to be restrained, especially during the transition to full decontrol.

Thus, provided that the flexibility we have discussed above is provided, it is entirely appropriate that Congress include in gas reform legislation provisions to safeguard consumers' interests in this manner along the lines proposed in S. 615.

We must emphasize, however, that adoption of any measure dealing with contracts alone will not provide a solution to the problems of the gas market.

V. CONCLUSION

Any effort to retain controls on some or all categories of supplies will inevitably yield market distortions analogous to those experienced under the Natural Gas Act and the NGPA. Some of those distortions are predictable; others are not. Experience indicates, however, that the Nation will be hurt more by an extension of full or partial controls than by ending our unfortunate experience with wellhead price regulation as soon as possible.

PGC applauds the Administration's initiative in submitting natural gas legislation. While we have indicated some concerns about certain specific provisions of the bill, we strongly support the goals of S. 615, with its complete deregulation of all wellhead gas prices by a date certain, combined with a market-oriented resolution to the NGPA's contract problem and prompt elimination of demand restraints. We intend to work with the Administration and Congress to achieve passage this year of a bill that will achieve these goals. The alternatives -- no bill or reregulation -- are unacceptable.

The Process Gas Consumers Group appreciates this opportunity to present its views on the specific legislative proposals before this Committee and will be pleased to answer any questions you may have.

January 14, 1983

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POSITION ON NATURAL GAS LEGISLATION

In order to increase the stability of the gas industry, enhance service to gas users, hold down prices for all consumers and eliminate the market distortions caused by the NGPA, the Process Gas Consumers Group (PGC) advocates the development of comprehensive gas legislation providing as follows:

1. Remove wellhead price controls from all natural gas as of January 1, 1985.

2. (a) In order to facilitate the renegotiation of any provision of existing contracts for the first sale of natural gas for resale, either party shall have the right to opt out of any such contract at any time between the date of enactment and one year after deregulation (i.e., January 1, 1986).

   (b) If the producer elects to opt-out of a contract, the purchaser shall have a right of first refusal as to the gas covered by that contract, provided that it agrees to accept all the terms and conditions of any new contract negotiated by the producer with a third party.

   (c) In the event the seller enters into a contract with a new buyer, the buyer under the original contract shall have a duty to transport the gas under terms which are just and reasonable.

3. Repeal incremental pricing (NGPA Title II) and the Fuel Use Act.

4. Provide for the mandatory filing with the FERC of all natural gas purchase contracts between the producers and pipelines, not later than ninety days after such contracts are executed. Such contracts shall be made public by the FERC.

5. (a) Provide for equal access to natural gas (including Outer Continental Shelf (OCS) gas) by all pipelines, distribution companies and end users.

   (b) Eliminate the interstate pipelines' right of first refusal as to NGPA "new" gas (i.e., Section 102 and 103 gas).

   (c) Eliminate the FERC's existing abandonment authority with respect to pre-NGPA (old") gas (i.e., its authority to enforce continued dedication of such gas to the interstate market even after expiration of the operative contract), but give interstate pipelines a right of first refusal with respect to the natural gas service proposed to be abandoned.

6. PGC strongly opposes any so-called "windfall profits tax" on natural gas.

Senator Murkowski. I have a few questions that I prepared, and I think they also represent some questions that the chairman also was interested in a response to.

As large-scale consumers of natural gas, you generally see a need to balance your needs for a fair price with your needs for long-term deliverability. We would like to know in what ways you perceive the decontrol of old gas as being in the best interests of your long-term deliverability goals.

Yes, go ahead, Mr. McNamara.

Mr. McNamara. Mr. Chairman, Pat McNamara.

I think that the way that we see the decontrol of old gas benefiting long term is by allowing the more efficient production of gas, the more rational choices of what gas is produced. For the same amount of capital investment, if you allow the producers to make the logical choices rather than drive them to make the choices where it cost them perhaps eight times as much to drill, we will believe that that will bring forth more gas long term.

Mr. Beatty. I would like to add to that, if I may. I think that it has been widely overlooked that there are two levels of competition in the natural gas market. There is the obvious interfuel competition that occurs at the burner tip between gas and fuel oil, and even in the extreme although widely overlooked fuels like coal for large utility boilers.

Obviously, the response time for fuel switching to those is much longer than the immediate switch that can occur between boilers or noncritical process uses between gas and oil, and can be made momentarily in a short time period, and will respond very quickly to prices.

But the added advantage occurs back at the producer pipeline interface, the intrafuel competition. And the proposed bill by the administration, S. 615, will encourage more competition at that level between producers and pipelines, and they will seek out, and have the incentive to pass forth the lowest cost mix of natural gas, because they have already hit the interfuel price ceiling.

They can no longer sell $8 gas in the marketplace. So the only place that producers have to go is for old gas, which is not price controlled below economical recovery levels, and look for enhanced recovery, additional finds, or whatever of low production cost gas. And that is what this bill will do for us.

Senator Murkowski. Mr. Chairman, I was asking some questions of the panel.

The Chairman [presiding]. Please proceed.

Senator Murkowski. Thank you, Mr. Chairman.

Do you believe that the failure of Congress to decontrol gas would result in overall market distortions?

Mr. Beatty. Yes, sir. It has already occurred with the lack of decontrol of old gas. We have all kinds of distortions. We are encouraging high cost production in deep gas, tight sands gas, and imported gas. And we are doing nothing to enhance the production of low-cost gas.

Senator Murkowski. You represent a group collectively who are substantial users of natural gas. And I am interested in a reference that was made by the president of the American Gas Association, which I believe the general assumption to be that he is opposed to the administration's proposal.

I wonder if any of you might comment on why you feel that that particular association would be opposed, when you gentlemen who equally represent substantial users of gas are in support?

Mr. McMAMARA. Mr. Chairman, I find it very difficult to understand why the president of the American Gas Association would take that position, particularly since the President's proposal and Mr. McClure's bill, as he has submitted it, gives them many of the things that they have asked for; the relief on take or pay, the increased opportunities for distribution companies to not be tied to pipelines any longer,

The many things that they have asked for over the period of the last 2 to 3 years are in this bill, as I understand it. And I really cannot understand that position, is that the position.

Senator MURKOWSKI. Is your organization, the Petrochemical Energy Group, part of the American Gas Association?

Mr. McNAMARA. No, sir, we are not.

Senator MURKOWSKI. Is there any representation on the panel, or would anyone else care to comment on why the president of the American Gas Association would be opposed to this legilation; Mr. Elam?

Mr. ELAM. I do not spend a lot of time telling people why they ought to make up their minds my way instead of theirs. But I will tell you this. Our reaction is based on pure skepticism. 48 hours before I had to go and inform two of our plants that they must shut down in the winter of 1976 and 1977, our gas supplier assured us that he had plenty of gas for us.

Senator MURKOWSKI. Does anyone else care to go on the record; Mr. Beatty.

Mr. BEATTY. I would add that we have experienced the same phenomena with our members, and the gas companies in general have not in our opinion, have not done an adequate job of assessing what the true market clearing levels are for various aspects of their load, and hence are having difficulty just assessing what their position should be.

Senator MURKOWSKI. It might be interesting to hear his testimony tomorrow.

Mr. ELAM. And your examination of him.

Senator MURKOWSKI. A couple of more questions, and we are getting brutally frank now. Secretary Hodel displayed a chart yesterday. And my total knowledge of the intricacies of gas marketing probably leaves something to be desired.

But the indication was that the average wellhead price is somewhat in the area of $2.75 to $3.50, and in the range thereof.

The question specifically, gentlemen, is in your candid opinion with this proposed legislation passing, and the gradual decontrol of gas, are we likely to see a decrease in this figure or an increase after decontrol has taken effect?

Mr. McNAMARA. Sir, a clarification.

Are you speaking of the average wellhead price?

Senator MURKOWSKI. That is correct.

Mr. McNAMARA. I will attempt to comment on that, sir. I think that the answer is I do not know. The President and the Department of Energy has made a forecast as best as they can where they suggest under the bill, that there would be 10 to 30 cent drop at the consumer level over the next 2 to 3 years. They have indicated very significant benefits to the United States.

Senator MURKOWSKI. Do you believe that?

Mr. McNAMARA. I think that that is reasonable from what I know of the current market situation; yes, sir.

Senator MURKOWSKI. So you would believe that?

Mr. McNAMARA. Well, I tend to believe that based on what I know. But I think that we have to be realistic here, sir. That there is uncertainty in life, but we cannot say for sure what is going to happen. What we can say are what are the benefits of moving from the free enterprise system that encourages the most efficient lowest cost production rather than the kind of distortions we have seen, were we see old gas shut in, and we see Algerian gas coming in.

I was in Michigan last week, and there is a story about how prices are going to rise for over 1 million Michigan consumers by 20 percent. And it is because we are sending U.S. dollars at $8 a 1,000 to Algeria instead of developing those resources here.

Senator MURKOWSKI. You speak of your uncertainty.

Is it the uncertainty of the formula that goes into the make-up of the gas cap in the proposed legislation?

Mr. McNAMARA. No, sir. I think that the formula is pretty straightforward.

Senator MURKOWSKI. Well, that formula and that gas cap are going to be the determining figure on whether the $2.75 is going to be higher or lower.

Mr. McNAMARA. Yes, sir, that is right. The gas cap is a surrogate for the free market, and is an attempt to estimate the free market in the smoothest transition. And there are thousands of contracts that are involved here. I do not think that anybody is enough of a seer to say exactly where that is.

I think that we can give some ranges and some expectations, and that is what I have given.

Senator MURKOWSKI. Do you think that it would be more appealing if there were some way to with a greater degree of certainty have a fixed cap by averaging out your new and old gas as a simple formula?

Assuming that you have 50 percent of your old gas as a reserve, and 50 percent of your new gas as a reserve, and you mix it, you are going to get a figure that is about $2.12 in this case. That would provide certainty. It is an extremely simplistic approach, probably too simplistic.

Mr. BRYAN. If I might respond to your question. If world oil prices continue to fall, and I think that most estimates are that they will, perhaps even much lower than has been talked about in the press, there is no doubt in our mind that gas prices would also drop as a result of complete decontrol.

If you had free market conditions in the pricing of gas, the competitive pressure of oil would have to cause those gas prices to fall. Mr. Elam referred earlier to the fact that after the boiler owners switched to oil, all that is left if the process gas consumers and the residential owners.

But interestingly, the energy technical expert in my company told me the other day, that we are purchasing certain process gas in South Carolina, and he says that No. 2 fuel oil, which in that process is a substitute for it, is right now only 7 cents a gallon away from the lines crossing, and about 15 cents a gallon away from the margin dropping to zero, the gas mark-up margin.

So even in upcoming months as oil prices fall, even process gas is going to come under competitive pressure from oil and other alternate fuels.

So in a free market with falling oil prices, there is no doubt that the oil consumers will be better off in a decontrolled environment, where low cost old gas can be brought into production.

Senator MURKOWSKI. I would like to give the rest of you a chance to just comment on whether you feel it is up or down, whether the price is going to be more or less. And we will start with Mr. Beatty.

Mr. BEATTY. In the comparison of the NGPA, the continued NGPA, and S. 625, we believe that prices will go down.

The CHAIRMAN. Thank you.

Mr. Bryan.

Mr. BRYAN. I just answered your question, prices will go down.

Senator MURKOWSKI. Mr. McNamara has already answered.

Mr. Elam.

Mr. ELAM. I think that they will go down.

Senator MURKOWSKI. The only last question that I have, and it pertains to my particular State. We have an unique situation where we have power generation virtually on top of a gas well. And our concern is that without some type of regulation, in 1986 the rates could go whatever. Because there is no competitive alternative as there is through the network of our natural gas system.

Could you provide some assurance as in the particular case of Alaska, that we might have some type of regulation that would protect us, or do you feel that the free market will take care of it? Because there is no competitive market. You understand, I think.

Mr. GOOCH. Sir, my name is Gordon Gooch. May I call your attention to the recent Supreme Court case in the Kansas Power & Light matter, that made I think basically two points that are material to what you are saying.

One is that the Natural Gas Policy Act discriminated against the intrastate market. So that it was fair for the States to regulate to counterbalance the effect of the NGPA. And doing so, they referred to the residual power of the States to regulate the commodities anyway.

So I suggest to you that the removal of Federal price controls does not leave the State of Alaska without any choice at all.

Senator MURKOWSKI. Thank you.

Mr. Chairman, thank you.

The CHAIRMAN. It would also be true if section 602(a) of NGPA is not repealed. It might have some effect on the ability of the State to respond to that kind of a problem. The administration bill does not propose the repeal of that section, as I understand it.

Senator Johnston.

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Chairman, I am sorry that I missed the panel's testimony in chief. I was handling the jobs bill for the minority on the floor, and could not be here. I will read all the statements.

But I would like for the panel to let me know, probably in writing would be the best way to do it, first whether you would support S. 615, if it is not amended. And I hasten to say that I will be offering some amendments, particularly on the pass-through and on the cap, which I hope will pass. But I would like to have your attitude, if it is not amended, just in case if for some reason the committtee does not see the obvious wisdom of those amendments.

Second, how you would amend it, or any other bill before us. And third, whether you support any of the other bills before the committee. I would like very much to get your advice on that. If you have an amendment, in other words, please give some good wording to carry it out.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Nickles.

Senator NICKLES. Thank you, Mr. Chairman. And I likewise happened to be testifying on a day that is very, very active on the floor, and will probably continue to be very active. I might forewarn some of the other panelists. It is very active today, and we just apologize for that.

Because a lot of us are very interested in this issue, and very interested in what you have to say. So at least your statements will be reviewed by myself, and ourselves, and others, that have a great interest in our.

Would it be fair to say that the panel is supportive of the concept of decontrol?

Mr. MCNAMARA. Yes, sir.

Mr. BRYAN. Yes, sir.

Senator NICKLES. Now you are as a panel are the chemical manufacturers, the industrial boiler owners, the petrochemical, and process gas consumers, so you are large users, large buyers of natural gas in making your product.

Is that correct?

Mr. ELAM. Yes, sir.

Senator NICKLES. And natural gas is a significant part or portion of your cost in your business, a very significant portion?

Mr. ELAM. Senator, we have members who pay over $200 million a year for gas.

Senator NICKLES. And yet even though you buy a lot of gas, we had a previous panel that said that the price of gas would go through the roof or something, if gas was decontrolled, even in lines with the administration's bill.

Would you comment on that, do you believe that is the case, and how do you see the impact of this bill toward your business?

Mr. ELAM. Senator, I am Jack Elam of the Process Gas Consumers Group. One thing that these discussions tend to overlook is that our companies employ thousands and thousands of people. And we do not want those people unable to pay their residential heating bill. That is the last thing we want.

And when we appear before you, and argue for a free market, we think that we are just as much arguing in favor of those employees as we are worrying about costs, and profits, and the sale of our products. That is the only comment that I know to make to you about our confidence in a free gas market.

Mr. **McNamara**. Senator, I would like to comment. And as co-chairman of the Petrochemical Energy Group, I would like to first make it clear that our members are independent petrochemicals. They hardly associate with oil companies. They certainly are not part of oil companies.

We are definitely consumers of the gas companies, as are residentials. And this is one of the things that we have had a great deal of difficulty getting recognition in general. That is we do not have any more reason to have our prices go up than anybody else.

Certainly, the petrochemical industry has been very severely affected along with many others in this recession. We are not out to raise our prices. We are out to have lower prices and good supply. We are not out to export jobs to other countries, as the National Gas Policy Act tends to do. We are out to keep those jobs here.

So we are consumers, and that is a very important point. We believe that this bill, this deregulation, will lead to lower cost long-term gas. This bill provides short-term protections, and that is why we are favoring it.

Senator **Nickles**. Can you or anybody else on the panel go into that a little bit more in detail.

Do you believe that by moving either through this vehicle or something similar toward a more rapid deregulation of all gas, why that will be of economic benefit, and why that will lead to lower gas prices?

Because that is a big issue. I think that even those who have indicated that they might oppose this—I mean you are big buyers of natural gas. You are not incidental buyers of natural gas. You are big buyers of natural gas. And the price of natural gas has a great deal of input on you and your employees as far as the cost of gas.

Mr. Beatty, would you care to possibly explain to us why you think that the gas prices would be lower under this proposal than to leave NGPA the way it is?

Mr. **Beatty**. Yes, I would, Senator. The chemical industry consumes about 2 trillion cubic feet of gas annually. We are the largest industrial sector. Gas prices in most areas of the country have now reached the interfuel price clearing level of No. 6 fuel oil. And the amount of load loss that is potential at that level in industrial, mostly boiler, but also some noncritical process use, and also utility boiler, is consideration.

A Gas Institute research study of last year estimated that there was a short term, that is almost immediate capability, of 3.8 quads of fuel switching. Within a year, that could be increased to 5.2. And with a leadtime of as much as 4 years, and construction obviously is the limitation, could approach 5.9 quads.

There is no way that gas producers and transporters can afford anything approaching that magnitude of load loss. They are at the ceiling. And as long as we retain cost of service pricing at the distribution company level to final customers, the pressure and the market signals are going to go back down through the distribution companies' pipelines to the producers, and with the ability of deregulation of all categories of gas, producers and pipelines are going to be searching for their lowest cost mix of gas.

And that is why we believe that prices will go down.

Senator NICKLES. Are there incentives now for producers or pipelines to be looking for the lowest cost under the present NGPA?

Mr. BEATTY. No, sir, we do not believe that those incentives are adequate. Because Congress attempted in the establishment of 28 categories to guess what the production costs would be for each category of gas. And it is very obvious by the record at this point in time that we have misestimated those categories.

Because there is no incentive for additional production of low cost gas, while there is incentive for imported gas and high cost gas, deep wells and tight sands production. And that is a distortion that has contributed to the price increases that all consumers are now seeing.

Senator NICKLES. So to complete my first question, then you feel that the real limitation would be coming from the fact that you have competitive alternate fuels, which you mentioned No. 6.

What is the price of No. 6 right now per barrel?

Mr. BEATTY. I think that it is generally acknowledged to be around $30 a barrel. Excuse me, that is crude oil. No. 6 is actually running lower than that.

Mr. BRYAN. We pay about 60 cents a gallon, Senator.

Senator NICKLES. 60 cents a gallon.

And how does that compare or equate per Mcf?

Mr. BEATTY. About $4.50, I think.

Senator NICKLES. And so what you are saying is that those prices have put an effective cap, if you wanted to call it that, as far as on market clearing levels, where even if you did deregulate, that the market is going to say wait a minute, gas prices, you are not going to be able to exceed that amount.

So you would see some gas prices that are imports or 107, or tight sands or something possibly would be coming down, and the others may be coming up. But you would have a lower long-run cost for consumers?

Mr. BEATTY. That is correct.

Mr. ELAM. May I add a comment to that, Senator.

With due respect to the previous panel, I was struck by the fact that in your colloquy with them, they never mentioned the market-out provision, which I think is the answer to the whole thing.

Senator NICKLES. That is an interesting point.

Mr. MCNAMARA. Following up on your question, Senator, about why we think that deregulation would benefit, I think that you have to look at what has happened under regulation. The controls on old gas have not benefited the consumer. They are perceived as a benefit, but the truth is that they really are not.

Because they cause offsetting overbidding. And if you will take a look at table 2 and 3 attached to your testimony, you will see the data that tells the truth. People talk about volume, but they do not talk about the price.

And you will see that even though there may be a large volume of so-called old gas and a small volume of so-called high cost gas, that the percentage of that high cost gas and the new gas, the make-up of the pipelines' total cost is very, very significant.

And that overbidding is encouraged and supported by the controls on old gas. The consumer is being misled when they are being told that the controls on old gas are any benefit to them. All it does is shift things from one place to another, particularly out of this country.

Senator NICKLES. That is very interesting.

Mr. MCNAMARA. And causing inefficient use of capital.

One other point that I would like to make. I keep hearing this idea that decontrol of old gas would not produce any more gas. Sun testifed before Mr. Sharp last year. They said that they looked at their old gas wells. And just 10 percent of them would benefit from reworking under not only decontrol, but just raising the price to 102 prices.

That 10 percent of the old wells of one company alone, they estimated would add 54 billion cubic feet of supply of gas. It is incorrect, absolutely incorrect, to say that decontrol of old gas would have no effect on supply.

Senator NICKLES. I agree with your comment. We have a lot of old gas in my neighborhood. And a lot of those have either been prematurely abandoned, or will be due to the fact of the low prices that we had, and would continue to have, if we continued under NGPA. And certainly, we would not see extended development or expansion in those wells.

I thank the panel.

The CHAIRMAN. If I might just make one reference to your table and ask one question in regard to that table. Does that include imports?

Mr. MCNAMARA. No, sir.

No, it doesn't, sir.

The CHAIRMAN. And if the imports were included, that would increase the volume of high cost?

Then, it is essential that either new gas, or high-cost gas generally, the high-cost gas price on the imports——

Mr. MCNAMARA. Sir, I don't understand exactly.

The CHAIRMAN. Well, the new gas costs more than the old gas.

Mr. MCNAMARA. Yes.

The CHAIRMAN. The high cost is the highest of all and the imports fit into that last category?

Mr. MCNAMARA. I believe they would.

The CHAIRMAN. One of the things that we are looking at and trying to determine is what kind of leverage that has on the market test—if volumes went down, that is shifts—the take-or-pay provision, and therefore, the high-cost volumes have more leverage, and it will depend upon the volume of take-or-pay as well as the volume of high-cost gas per pipeline.

Mr. GOOCH. Sir, I just wanted to call your attention to the General Accounting Office study that was requested by Senator Eagleton, and if I read that report correctly—it came out, I believe, in October 1982, the GAO was unable to conclude that the take-or-pay contracts themselves that had caused this conduct; and certainly the FERC has been unable to conclude that because they haven't granted certificates in the onsystem dump sale cases, or condition the certificates; so, that, I am not prepared to accept as a complete explanation that take-or-pay contracts are driving this type of conduct.

The CHAIRMAN. Each of you represent the large industrial concerns. If I recall correctly, your industries generally—those that you represent—consume about 38 percent of the total volume; is that correct?

Mr. MCNAMARA. Senator, I believe it is somewhat higher than that. I have seen figures about 41 percent for industrial use in the United States.

We do have a table here that is—it is 41.2 percent according to EIA data, as of July 1982, as industrial, sir.

The CHAIRMAN. Well, give or take 1 or 2 percentage points—around 40 percent?

Mr. MCNAMARA. Yes, sir.

The CHAIRMAN. And you believe that that is a sufficient volume that your willingness to pay a price affects the producer price at the wellhead?

You are also, I am certain, large enough that you have the capability to negotiate directly with producers.

Now, some of the larger—some of the smaller consumers wouldn't have the same ability to negotiate at the wellhead. I think that would probably be an acceptable statement.

If any of you disagree with that, I wish you would say something.

Mr. MCNAMARA. Well, Senator, I think—I don't know how small a consumer you are talking about, if you are speaking of an individual person or not; but certainly those whom we normally think of as making up the natural gas market—distribution companies, pipelines, and so forth, in general, are as large or larger than many of our individual companies.

And I think one of the things that this bill does is to open up that possibility.

Right now, distribution companies more than anybody else are on the tail end, and would have to accept what they can get.

This is in their favor, the best I can see, sir.

Mr. BEATTY. Mr. Chairman——

The CHAIRMAN. Mr. Beatty.

Mr. BEATTY. I would add the observation that if the producers and the pipelines and the distribution companies are doing their job of offering the lowest cost mix, we will have no need for that provision.

Mr. MCNAMARA. Senator, could I add one more point?

The CHAIRMAN. Of course.

Mr. MCNAMARA. One of the things that is in the interest of the individual consumer and the people on the end of the pipeline, in general, is to have competition for the pipelines from other users, and this competition, as we know, tends to drive people to work the hardest.

And, by having some alternative competitions, we believe that that competition will help the pipeline to seek to do a better job for their customers too, as well as the distribution companies.

The CHAIRMAN. It has been argued by many, with respect to the provisions of the bill that would permit the producers of old gas to abrogate their contracts on January 1, 1985, that virtually all the old gas contracts would be abrogated and the producers would just sit back and wait for the highest bidder and would eventually sell the gas for a much higher price.

Do you think that is a substantial possibility?

Mr. **Beatty**. No, sir. Not at all, because we are already at a very significant interfuel market clearing level--that is No. 6 fuel oil, and there is just too much fuel there—too much load there for the gas industry, for the producers and pipelines to lose by attempting to just have the lower priced contracts go up. Every lower priced contract that goes up will have to be matched by a higher priced contract coming down, or the average price is going to increase and there is going to be a load loss.

The **Chairman**. Is there any other comment?

Mr. McNamara.

Mr. **McNamara**. Yes, sir.

I think Mr. Beatty's last point is an essential one. The idea that producers can only raise the price on old gas, regardless of what the market is, ignores the fact that there is a market, the fact that they have to sell it.

It also ignores the fact that the high-cost contracts on the other end are going to tend to be held to the late, to the last bit, too.

Why is it that low-cost contracts should come up, but high-cost contracts should come down?

Our testimony emphasized the fact that this bill, we believe, includes balance and fairness for all parties; and I think it is inappropriate to concentrate—speak one way on one party and the other way on the other party.

The **Chairman**. Mr. Elam.

Mr. **Elam**. We think both will happen, Mr. Chairman. High and low will be renegotiated.

The **Chairman**. It is suggested that while you are large enough to be able to exert that kind of market pressure, that somehow the home heating market—the burner tip in the home—is not represented adequately by the pipelines.

I think you, more or less generally, across the board, refuted that argument.

Is there any further comment that you would make there? Since you are not really representative, I know, Mr. Elam, you indicated that you had concern for your employees, and I am sure that is true.

Mr. McNamara.

Mr. **McNamara**. Thank you, Senator.

I tried to make that point before, and let me see if I can do a better job of it.

Many of our companies and the large industrial users are really customers of the pipelines, and in some cases, distribution companies.

It is because there would be the opportunity under this bill for those companies if they are dissatisfied with the service and the supply and the price they are getting, to go it directly.

That provides a downward pressure. The pipeline naturally would like to keep us as customers, we would think, because we provide a large part of the load which underwrites the basic operating and capital costs that keeps those loads from going on to residential consumers.

All those factors, it seems to me, are in favor of all the consumers of pipeline by increasing competition.

The CHAIRMAN. One final question, and then we will submit some for the record, for your responses in writing.

It has been suggested by some that we need the price incentive of high-cost gas for the incentive to produce; that if you don't have the old, low-cost gas to roll in the new high-cost gas, you reduce the incentive to go out and produce additional supplies.

How do you respond to that argument?

Mr. Beatty.

Mr. BEATTY. Mr. Chairman, that concern makes no sense to us, to spend an extra dollar now for some future event that we are not sure is going to occur. We would rather have our savings now, maximize the production of the lowest cost mix of gas, and if we find more gas, why we won't ever have to worry about that problem; and if we don't then prices will go up naturally and the market will retain some balance between the various energy sources.

The CHAIRMAN. Mr. Bryan.

Mr. BRYAN. The difficulty with that kind of question is that there really isn't any low price or medium price or high price that provides sufficient incentive. The price that provides a sufficient incentive is the price where the market clears, and if you don't have enough gas, that there is a shortage of supply, the price is going to go up to the point where more gas is going to be produced; and vice versa.

So, I think to try to sit here and say: "Well, such and such a price will provide sufficient incentives," I think, misses the whole point; and in the free market, that price will be determined by the market, and the supply and demand will always balance.

The CHAIRMAN. Mr. McNamara.

Mr. MCNAMARA. Senator, I believe in the law of supply and demand also; and I think the question here is: Who is in the best position to determine what is the best place to drill?

Under the idea that the Federal Government has to determine where producers should drill, and knows more about it, we tend to end up with this kind of thing, and, as the President said, in his radio address—as Mr. Jefferson said, there are those who believe in the decisions of many, and those who don't.

I happen to be one who believes in the decisions of the many, and leaving the expertise as to where to go for the best chances and the lowest cost to those who are in the business rather than to the Federal Government.

The CHAIRMAN. Mr. Elam.

Mr. ELAM. Well, Mr. Chairman, we are talking about proposing a free market. The textile market, which is the one that I know a little something about, is a free market. Blue jeans are made out of denim and corduroy now.

If those people who are advocating what you just said were running the textile market, they would be made out of satin, I guess; but I don't think that is the way the market ought to operate. [Laughter.]

Senator NICKLES. Well, are you proposing that? [Laughter.]

Mr. ELAM. I had better not.

The **Chairman**. Well, maybe there are those who think the public would be better off if we had satin jeans.

Gentlemen, thank you very much for your patience in waiting to testify as we were interrupted.

I appreciate your testimony today.

Our next panel will consist of Mr. Wayne Harmon, the executive vice president, Louisiana Association of Independent Producers Royalty Owners; James V. Walzel, president of Houston Pipeline; J. L. Terrill, president, Louisiana Intrastate Gas Corp.; Mr. Bill Greehey, chief executive officer, Valero Energy Corp.; Mr. Vernon T. Jones, executive vice president of the Williams Cos.

Gentlemen, as with the previous panel, we have your prepared statements. They will be made a part of the record in full.

I appreciate those statements and having them so that we can analyze them in advance. I will invite you to summarize your statements rather than attempt to give them in full so that we can have time for a few questions before we run out of time today.

Mr. Harmon.

STATEMENT OF C. WAYNE HARMON, EXECUTIVE VICE PRESIDENT, LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS & ROYALTY OWNERS

Mr. **Harmon**. Thank you, Mr. Chairman.

My name is Wayne Harmon. I am executive president of LAIPRO—Louisiana Association of Independent Producers & Royalty Owners.

LAIPRO is a State trade association in Louisiana which represents more than 1,800 members and promotes the interests of independent oil and gas producers, royalty owners, geologists, landmen, and others with operations in the State of Louisiana.

The views and comments presented today are the views of the association.

Independent oil and gas producers and other groups in Louisiana have long supported full and total decontrol of natural gas prices at the wellhead.

We intend to continue our drive to seek legislative decontrol of natural gas during the 98th Congress.

Congress has an excellent opportunity to change natural gas legislation through the initiative offered by the administration through the introduction of S. 615.

I would like to present a brief Louisiana overview, which can provide a better understanding of the natural gas situation in the State and the need for the removal of Federal controls on access to all natural gas supplies, their use and transportation, and the accelerated decontrol of all natural gas prices.

Federal controls on the wellhead price of natural gas and arbitrary restrictions on the industrial use of gas are and have been creating problems for Louisiana's producing, transporting, and consuming industries for years.

Those same controls also restrict Louisiana's access to gas supplies from the Outer Continental Shelf and excess supplies in other States.

Much has been said about the importance of Louisiana as a producing State. Since the discovery of the first natural gas well in the early 1900's, many thousands of wells have been drilled in all areas of Louisiana, including offshore.

Louisiana has oil or gas production in each of its 64 parishes. Louisiana is the No.1 exporter of natural gas in the United States, accounting for some 30 percent of all lower 48 production and 28 percent of the reserve.

What is, perhaps, less understood, Mr. Chairman, is the role of Louisiana as a consumer of natural gas. Louisiana is third in the United States in total consumption of natural gas and No. 1 consumer on a per capita basis, some 50 percent greater than the second-place State—Texas.

The primary reason for this huge consumption is the industrial complex which has developed along the Mississippi River from New Orleans to Baton Rouge, and the complex in southwest Louisiana.

Approximately 62 percent of all gas consumed in Louisiana is used by industry. Another 30 percent is used by utility companies in the generation of electricity and only 5 percent goes to residential use.

This is in great contrast to most other States. For example, the breakdown for the remainder of the United States is 37 percent industrial and 28 percent residential.

It is obvious that this mighty industrial complex developed in the State of Louisiana because of the plentiful availability of natural gas.

However, Louisiana industry now finds itself in the almost incomprehensible situation of being at a competitive disadvantage, both in price and availability, with the natural gas using industry in the remainder of the States.

This condition exists because of the effects of Federal regulations, past and present, on Louisiana gas production, transmission, and use.

This condition has developed over a number of years, but has reached crisis proportions since the passage of the NGPA of 1978.

Prior to the NGPA, all producer wellhead sales to interstate pipelines were regulated by the Federal Energy Regulatory Commission with maximum ceiling prices governing the amount which the producer could receive for that gas.

Intrastate pipelines were outside the jurisdiction of the FERC and wellhead prices were not regulated. Eighty percent of all Louisiana industrial gas is supplied by the intrastate systems.

During this period of the early 1970's and prior to the passage of the NGPA, Louisiana's intrastate lines attracted large amounts of reserves and deliverability to their systems.

Intrastate pipelines paid higher prices for natural gas prior to 1978 than could the regulated interstate lines; and, consequently, established higher average cost of natural gas.

Interstate lines were able, therefore, to bid a higher price—in fact, much higher—than market clearing prices, for decontrolled gas.

By blending this expensive new gas with the cheaper old gas, a marketable mix was achieved.

And intrastate line was in the position of having to bid an equally high price for decontrolled gas in order to compete, resulting in a higher average gas purchase price for the intrastate pipeline.

The other alternative was not to compete for the gas, and as a result watch that gas be committed to the interstate system.

I have up to this point limited my remarks to the position in which Louisiana now finds itself. I will not address any additional problems attendant to the current control of the market except to mention that all of these market distortions are clearly the result of only one thing. Government regulation and its interference in the place of the free market system.

The problems have developed because of artificial price controls, and they will not go away until the Government removes those controls and lets the marketplace establish a true value for natural gas.

That value, or price, must be high enough to attract investment in order to find adequate supplies of new gas for the future at a price low enough to enable it to compete in the energy marketplace.

The CHAIRMAN. Mr. Harmon, I hate to interrupt, but if we are going to hear all of the witnesses and get to some questions, I will have to ask you to summarize in about a minute.

Mr. HARMON. All right.

Let me summarize, Mr. Chairman, by going to page 8 which offers some problems that we see in the bill itself as far as some fallacies are concerned.

This bill offers disincentives, in our opinion, for new exploration of natural gas supplies for the period between the date of enactment and January 1, 1986.

We think it is vitally important to maintain production incentives for new exploration.

If producers are not offered proper investment incentives for new exploration and drilling activity, it will result in monumental disservice to consumers of this country, and we will find ourselves back in a demand, rather than a supply situation.

Many small operators and Louisiana independent producers have, since enactment of the NGPA, committed themselves to long-term debt with banks and investors by going out and finding new gas based on a market-clearing price—under sections 102, 103, and 107 of NGPA.

If those natural gas prices are rolled back, many producers will find themselves in severe financial difficulty, unable to meet prior commitments.

And, lastly, it seems to LAIPRO that the proposal is built around the objective of increasing old gas—section 104 prices while decreasing or rolling back the new gas prices—section 102 and 103.

We believe the attempt to raise old gas prices and lower new gas prices is not in the best interest of the country, and the industry, or the consumer.

And, to finish the statement, Mr. Chairman, I will leave it to the committee. We do make some specific suggestions, on the last three pages of our statement.

The CHAIRMAN. Yes, sir. We have those statements; they are part of the record, and I appreciate your comments today.

[The prepared statement of Mr. Harmon follows:]

STATEMENT OF

C. WAYNE HARMON
EXECUTIVE VICE PRESIDENT
LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS & ROYALTY OWNERS

BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
MARCH 10, 1983

S.615 - NATURAL GAS CONSUMER REGULATORY REFORM AMENDMENTS OF 1983

THANK YOU MR. CHAIRMAN. MY NAME IS WAYNE HARMON. I AM EXECUTIVE VICE PRESIDENT OF LAIPRO - LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS AND ROYALTY OWNERS. LAIPRO IS A STATE TRADE ASSOCIATION IN LOUISIANA WHICH REPRESENTS MORE THAN 1,800 MEMBERS AND PROMOTES THE INTERESTS OF INDEPENDENT OIL AND GAS PRODUCERS, ROYALTY OWNERS, LANDOWNERS, GEOLOGISTS AND OTHERS WITH OPERATIONS IN THE STATE OF LOUISIANA. LAIPRO IS HEADQUARTERED IN BATON ROUGE, LOUISIANA.

THE VIEWS AND COMMENTS PRESENTED TO THE COMMITTEE TODAY ARE THE VIEWS OF THE ASSOCIATION AS TO THE IMPACT OF THE NATURAL GAS POLICY ACT OF 1978 ON THE CURRENT AND PROJECTED NATURAL GAS MARKET AND ON THE ADMINISTRATION SUPPORTED S. 615 - THE NATURAL GAS CONSUMER REGULATORY REFORM AMENDMENTS OF 1983. MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, WE COMMEND THE COMMITTEE FOR ITS INTEREST IN THIS ISSUE AND THE OPPORTUNITY FOR LAIPRO TO SHARE ITS VIEWS.

INDEPENDENT OIL AND GAS PRODUCERS AND OTHER GROUPS IN LOUISIANA HAVE LONG SUPPORTED FULL AND TOTAL DECONTROL OF NATURAL GAS PRICES AT THE WELLHEAD. WE INTEND TO CONTINUE OUR DRIVE TO SEEK LEGISLATIVE DECONTROL OF NATURAL GAS DURING THE 98TH CONGRESS. CONGRESS NOW HAS AN EXCELLENT OPPORTUNITY TO CHANGE NATURAL GAS LEGISLATION, THAT IS WORKING AGAINST THE BEST INTEREST OF THE NATION AND LOUISIANA IN PARTICULAR, THROUGH THE INITIATIVE OFFERED BY THE ADMINISTRATION THROUGH THE INTRODUCTION OF S.615 & H.R. 1754.

AT THIS POINT, MR. CHAIRMAN, I WOULD LIKE TO PRESENT A BRIEF LOUISIANA NATURAL GAS PROFILE, WHICH CAN PROVIDE A BETTER UNDERSTANDING OF THE NATURAL GAS SITUATION IN THE STATE AND THE NEED FOR THE REMOVAL OF FEDERAL CONTROLS ON ACCESS TO ALL NATURAL GAS SUPPLIES, THEIR USE AND TRANSPORTATION, AND ACCELERATED DECONTROL OF ALL NATURAL GAS PRICES. ALTHOUGH THIS SITUATION EXISTS IN LOUISIANA, I WANT TO ASSURE YOU THAT WE DO NOT STAND ALONE -- PROBLEMS EXIST IN EVERY STATE, PRODUCING AND CONSUMING, AND WITH EVERY PRODUCER -- LARGE AND SMALL.

FEDERAL CONTROLS ON THE WELLHEAD PRICE OF NATURAL GAS AND ARBITRARY RESTRICTIONS ON THE INDUSTRIAL USE OF GAS ARE AND HAVE BEEN CREATING PROBLEMS FOR LOUISIANA'S PRODUCING, TRANSPORTING AND CONSUMING INDUSTRIES. THOSE SAME CONTROLS ALSO RESTRICT LOUISIANA'S ACCESS TO NATURAL GAS SUPPLIES FROM THE OUTER CONTINENTAL SHELF (OCS) AND EXCESS SUPPLIES IN OTHER STATES.

NATURAL GAS CONTINUES TO BE THE PRIMARY SOURCE OF ENERGY WHICH FUELS LOUISIANA'S HOMES, INDUSTRIES AND POWER PLANTS. TOTAL NATURAL GAS CONSUMPTION FOR 1980 WAS 1,398.5 BCF AT A WEIGHTED AVERAGE COST

OF $2.39 PER MM BTU. IN 1981, TOTAL NATURAL GAS CONSUMPTION FELL TO 1,307 BCF AND THE WEIGHTED AVERAGE COST ROSE TO $3.15 PER MM BTU. 1982 FIGURES ARE NOT YET AVAILABLE BUT THE AVERAGE COST WILL SURELY BE EVEN GREATER.

MUCH HAS BEEN SAID ABOUT THE IMPORTANCE OF LOUISIANA AS A PRODUCING STATE. SINCE DISCOVERY OF THE FIRST NATURAL GAS WELL IN THE EARLY 1900'S MANY THOUSANDS OF WELLS HAVE BEEN DRILLED IN ALL AREAS OF LOUISIANA -- NORTH AND SOUTH LOUISIANA, AND OFFSHORE. LOUISIANA NOW HAS OIL OR GAS PRODUCTION IN EACH OF ITS 64 PARISHES. LOUISIANA IS THE NUMBER ONE EXPORTER OF NATURAL GAS IN THE UNITED STATES ACCOUNTING FOR SOME 35 PERCENT OF ALL LOWER 48 PRODUCTION AND 28 PERCENT OF THE RESERVES.

WHAT IS, PERHAPS, LESS UNDERSTOOD IS THE ROLE OF LOUISIANA AS A CONSUMER OF NATURAL GAS. LOUISIANA IS THIRD IN THE UNITED STATES IN THE TOTAL CONSUMPTION OF NATURAL GAS AND THE NUMBER ONE CONSUMER ON A PER CAPITA BASIS, SOME 50 PERCENT GREATER THAN THE SECOND PLACE STATE -- TEXAS. THE PRIMARY REASON FOR THIS HUGE CONSUMPTION IS THE INDUSTRIAL COMPLEX WHICH HAS DEVELOPED ALONG THE MISSISSIPPI RIVER FROM NEW ORLEANS TO BATON ROUGE (KNOWN AS THE NOBAR STRIP) AND THE COMPLEX IN SOUTHWEST LOUISIANA IN THE VICINITY OF LAKE CHARLES.

APPROXIMATELY 62 PERCENT OF ALL GAS CONSUMED IN LOUISIANA IS USED BY INDUSTRY. ANOTHER 30 PERCENT IS USED BY UTILITY COMPANIES IN THE GENERATION OF ELECTRICITY AND ONLY FIVE PERCENT GOES TO RESIDENTIAL USE. THIS IS IN GREAT CONTRAST TO MOST OTHER STATES. FOR EXAMPLE, THE BREAKDOWN FOR THE REMAINDER OF THE UNITED STATES IS 37 PERCENT INDUSTRIAL AND 28 PERCENT RESIDENTIAL. A SAMPLE OF

INDUSTRIAL COMPANIES IN LOUISIANA SHOWS THAT 40 PERCENT GOES FOR BOILER FUEL AND 25 PERCENT IS USED FOR FEEDSTOCK.

IT IS OBVIOUS THAT THIS MIGHTY INDUSTRIAL COMPLEX DEVELOPED IN THE STATE OF LOUISIANA BECAUSE OF THE PLENTIFUL AVAILABILITY OF NATURAL GAS. HOWEVER, LOUISIANA INDUSTRY NOW FINDS ITSELF IN THE ALMOST INCOMPREHENSIBLE SITUATION OF BEING AT A COMPETITIVE DISADVANTAGE, BOTH IN PRICE AND AVAILABILITY, WITH THE NATURAL GAS USING INDUSTRY IN THE REMAINDER OF THE NATION. THIS CONDITION EXISTS BECAUSE OF THE EFFECTS OF FEDERAL REGULATIONS, PAST AND PRESENT, ON LOUISIANA GAS PRODUCTION, TRANSMISSION AND USE. THIS CONDITION HAS DEVELOPED OVER A NUMBER OF YEARS BUT HAS REACHED CRISIS PROPORTIONS SINCE THE PASSAGE OF THE NATURAL GAS POLICY ACT OF 1978.

PRIOR TO THE NGPA ALL PRODUCER WELLHEAD SALES TO INTERSTATE PIPELINES (THOSE CROSSING STATE LINES) WERE REGULATED BY THE FEDERAL ENERGY REGULATORY COMMISSION (FERC, FORMERLY THE FPC) WITH MAXIMUM CEILING PRICES GOVERNING THE AMOUNT WHICH THE PRODUCER COULD RECEIVE FOR HIS GAS. INTRASTATE PIPELINES (THOSE SYSTEMS TRANSPORTING NATURAL GAS TOTALLY WITHIN A STATE'S BORDERS) WERE OUTSIDE THE JURISDICTION OF THE FERC AND WELLHEAD PRICES WERE NOT REGULATED. EIGHTY PERCENT OF ALL LOUISIANA INDUSTRIAL GAS IS SUPPLIED BY INTRASTATE SYSTEMS.

DURING THE PERIOD OF THE EARLY 1970'S, AND PRIOR TO THE PASSAGE OF THE NGPA, LOUISIANA INTRASTATE LINES ATTRACTED LARGE AMOUNTS OF RESERVES AND DELIVERABILITY TO THEIR SYSTEMS. INTRASTATE PIPELINES PAID HIGHER PRICES FOR NATURAL GAS PRIOR TO 1978 THAN COULD THE

REGULATED INTERSTATE LINES AND, CONSEQUENTLY, ESTABLISHED A HIGHER AVERAGE COST OF NATURAL GAS. INTERSTATE LINES WERE ABLE, THEREFORE, TO BID A HIGH PRICE, IN FACT MUCH HIGHER, THAN MARKET CLEARING PRICES, FOR DECONTROLLED GAS. BY BLENDING THIS EXPENSIVE NEW GAS WITH CHEAPER OLD GAS -- A MARKETABLE MIX WAS ACHIEVED.

AN INTRASTATE LINE WAS IN THE POSITION OF HAVING TO BID AN EQUALLY HIGH PRICE FOR DECONTROLLED GAS IN ORDER TO COMPETE, RESULTING IN A HIGHER AVERAGE GAS PURCHASE COST FOR THE INTRASTATE PIPELINE. THE OTHER ALTERNATIVE WAS NOT TO COMPETE FOR THE GAS AND AS A RESULT WATCH THAT GAS BE COMMITTED TO THE INTERSTATE SYSTEM. DURING THE PERIOD FROM 1970-1977 AND ESTIMATED 42 TRILLION CUBIC FEET IN NEW RESERVES WERE COMMITTED TO THE INTRASTATE PIPELINES (ALL INTRASTATES, NOT JUST LOUISIANA) AND THE INTERSTATE SYSTEM SUFFERED A DECLINE IN NEW RESERVES OF FIVE TRILLION CUBIC FEET. AFTER PASSAGE OF THE NGPA (1978-1979) AN ESTIMATED 16 TRILLION CUBIC FEET OF RESERVES WAS COMMITTED TO THE INTERSTATE PIPELINES AND ONLY ONE TRILLION CUBLIC FEET TO THE INTRASTATES.

IN ADDITION, NO ACCESS TO OCS GAS, PROHIBITIONS AGAINST BOILER FUEL USE AND A DECLINE IN ONSHORE LOUISIANA PRODUCTION HAS PRESENTED GRAVE PROBLEMS TO THE INTRASTATE SYSTEMS.

I HAVE, UP TO THIS POINT, BRIEFLY LIMITED MY REMARKS TO THE POSITION IN WHICH LOUISIANA NOW FINDS ITSELF. I WILL NOT ADDRESS ANY ADDITIONAL PROBLEMS ATTENDANT TO THE CURRENT CONTROLLED MARKET EXCEPT TO MENTION THAT ALL OF THESE MARKET DISTORTIONS ARE CLEARLY THE RESULT OF ONLY ONE THING: GOVERNMENTAL REGULATIONS AND ITS INTERFERENCE IN PLACE OF A FREE MARKET SYSTEM.

THE PROBLEMS HAVE DEVELOPED BECAUSE OF ARTIFICIAL PRICE CONTROLS, AND THEY WILL NOT GO AWAY UNTIL THE GOVERNMENT REMOVES THOSE CONTROLS AND LETS THE MARKETPLACE ESTABLISH A TRUE VALUE FOR NATURAL GAS. THAT VALUE, OR PRICE, MUST BE HIGH ENOUGH TO ATTRACT INVESTMENT IN ORDER TO FIND ADEQUATE SUPPLIES OF NEW GAS FOR THE FUTURE AND AT A PRICE LOW ENOUGH TO ENABLE IT TO COMPETE IN THE ENERGY MARKETPLACE WITH ALL OTHER FORMS OF ENERGY -- COAL, LIGNITE, FUEL OIL, SOLAR, NUCLEAR, ETC. BECAUSE OF THE "ALICE IN WONDERLAND" SCENARIO OF BLENDING $9.97 GAS WITH 30 CENT GAS, I DON'T BELIEVE THAT ANYONE, NO MATTER HOW EXPERT, NOW KNOWS WHAT THE REAL VALUE OF NATURAL GAS IS, AND WE WILL NOT KNOW UNTIL A SUFFICIENT TIME IN A FREE MARKET ENVIRONMENT HAS ELAPSED FOR NATURAL GAS TO SEEK ITS TRUE VALUE. OUR ASSOCIATION BELIEVES THAT THIS TRUE VALUE IS LOWER THAN THE NGPA BLEND IN MARCH, 1983. HOWEVER, YOUR BILL, MR. CHAIRMAN, HAS SET UP A "GAS CAP" IN AN EFFORT TO CURB THE MANY FEARS OF A SHARP RISE IN PRICE WITH DEREGULATION.

I HAVE MET THIS WEEK WITH GROUPS OF INDEPENDENT PRODUCERS AROUND LOUISIANA IN AN EFFORT TO OBTAIN THEIR INDIVIDUAL VIEWS, CONCERNS AND COMMENTS ON THE PROPOSED LEGISLATION. TODAY I AM SPEAKING FOR THEM AND THE OTHER 1,800 INDEPENDENT PRODUCERS AND ROYALTY OWNERS LAIPRO REPRESENTS. LAIPRO MEMBERS ARE SMALL OPERATORS COMPARED TO THE "MAJOR" COMPANIES AND THOSE MEMBERS THAT WILL BE REPRESENTED HERE TOMORROW BY THE NATURAL GAS SUPPLY ASSOCIATION AND THE DOMESTIC PETROLEUM COUNCIL. MOST OF THE GAS PRODUCED BY INDEPENDENTS IS NEW GAS AND WILL, THEREFORE, BE DECONTROLLED ON JANUARY 1, 1985 -- SHOULD THE NGPA RUN ITS COURSE. A STRONG CASE CAN BE MADE THAT OUR INTERESTS ARE BEST SERVED BY LOBBYING FOR A CONTINUATION OF CONTROLS ON OLD GAS, OF WHICH WE AS

INDEPENDENTS HAVE RELATIVELY LITTLE, BASED ON THE PREMISE THAT WE WILL BE ABLE TO GET A PRICE ABOVE MARKET CLEARING LEVELS FOR OUR DECONTROLLED GAS. WE, AS AN ASSOCIATION, THINK THAT SUCH A POSITION WOULD BE TOTALLY IRRESPONSIBLE. IT IS OUR COLLECTIVE BELIEF THAT THE BEST LONG-RANGE INTERESTS OF THE UNITED STATES, IN TERMS OF ENERGY INDEPENDENCE, REQUIRE A STABLE AND PREDICTABLE ENVIRONMENT FOR NATURAL GAS EXPLORATION, PRODUCTION AND MARKETING. WE ALSO BELIEVE THAT THE LONG-TERM INTERESTS OF PRODUCERS; BOTH LARGE AND SMALL, REQUIRE THIS KIND OF STABILITY.

BY THE SAME TOKEN, WE ALSO THINK THAT EVERY GROUP, AREA, OR REGION OF THE UNITED STATES SHOULD ADOPT THIS POSITION. IT IS IRRESPONSIBLE FOR ANY INTEREST GROUP (PRO OR CON) BECAUSE OF CHEAPER GAS SUPPLIES CREATED BY GOVERNMENT REGULATIONS IN THEIR REGION, TO LOBBY FOR THE CONTINUATION OF ARTIFICIAL CONTROLS. WE, THEREFORE, RESPECTFULLY REQUEST THIS COMMITTEE TO EXPEDIOUSLY INITIATE STEPS TOWARD MAKING S. 615 A WORKABLE DECONTROL PLAN FOR THE DEREGULATION OF ALL PRICES AND CATEGORIES OF NATURAL GAS LEADING TO A FREE-MARKET BY 1986.

MR. CHAIRMAN, I WOULD LIKE AT THIS TIME TO COMMENT ON THE REAGAN ADMINISTRATION PROPOSED LEGISLATION -- S.615 -- THE NATURAL GAS CONSUMER REGULATORY REFORM AMENDMENTS OF 1983.

WE COMMEND THE ADMINISTRATION, THE DEPARTMENT OF ENERGY AND YOU, MR. CHAIRMAN, FOR PROPOSING LEGISLATION WHICH BROADLY SEEKS TO ACHIEVE TOTAL AND COMPLETE DECONTROL BY JANUARY 1, 1986. HOWEVER, WE FEEL A NUMBER OF CHANGES SHOULD BE MADE TO S. 515 AS IT IS CONSIDERED BY YOUR COMMITTEE AND THROUGH OTHER CONGRESSIONAL CONSIDERATION DURING THE COMING MONTHS.

LAIPRO BELIEVES THERE ARE SEVERAL FALLACIES IN THIS PROPOSED LEGISLATION. WE WOULD LIKE TO SHARE SOME OF THOSE MAJOR CONCERNS:

- THIS BILL OFFERS DISINCENTIVES FOR NEW EXPLORATION OF NATURAL GAS SUPPLIES FOR THE PERIOD BETWEEN DATE OF ENACTMENT AND JANUARY 1, 1986. WE THINK IT IS VITALLY IMPORTANT TO MAINTAIN PRODUCTION INCENTIVES FOR NEW EXPLORATION AS DID THE NATURAL GAS POLICY ACT OF 1978. IF PRODUCERS ARE NOT OFFERED PROPER INVESTMENT INCENTIVES FOR NEW EXPLORATION AND DRILLING ACTIVITY IT WILL RESULT IN MONUMENTAL DISSERVICE TO CONSUMERS OF THIS COUNTRY AND WE WILL FIND OURSELVES BACK IN A DEMAND -- RATHER THAN A SUPPLY -- SITUATION.

- MANY SMALL OPERATORS AND LOUISIANA INDEPENDENT PRODUCERS HAVE, SINCE ENACTMENT OF THE NGPA, COMMITTED THEMSELVES TO LONG TERM DEBT WITH BANKS AND INVESTORS BY GOING OUT AND FINDING NEW GAS BASED ON MARKET PRICING CATEGORIES UNDER SECTIONS 102, 103, AND 107 OF THE ACT. IF THOSE NATURAL GAS PRICES ARE ROLLED BACK -- MANY INDEPENDENT PRODUCERS WILL FIND THEMSELVES IN SEVERE FINANCIAL DIFFICULTY -- UNABLE TO MEET COMMITMENTS.

- IT SEEMS TO LAIPRO THAT THE ENTIRE PROPOSAL IS BUILT AROUND THE OBJECTIVE OF INCREASING OLD GAS (SECTION 104) PRICES WHILE DECREASING OR ROLLING BACK NEW GAS PRICES (SECTION 102,103). AS STATED EARLIER IN OUR STATEMENT -- INDEPENDENTS HAVE VERY LITTLE "OLD GAS". WE SINCERELY BELIEVE THE ATTEMPT TO RAISE "OLD GAS" PRICES AND LOWER "NEW GAS" PRICES IS NOT IN THE BEST INTEREST OF THE COUNTRY, THE INDUSTRY OR THE CONSUMER.

MR. CHAIRMAN, LAIPRO OFFERS THE FOLLOWING RECOMMENDATIONS FOR CONSIDERATION BY THE COMMITTEE AS YOUR WORK CONTINUES ON THIS LEGISLATION:

☐ AVOID THE ROLLBACK OF THE PRICE OF EXISTING GAS CONTRACTS ON DATE OF ENACTMENT OF THE BILL. IN OUR OPINION THE BEST AND MOST EFFECTIVE WAY TO PREVENT ROLLBACKS TO THE DETRIMENT OF THE PRODUCING INDUSTRY IS TO TREAT ALL NEW GAS (SECTION 102 & 103) THE SAME AS SECTION 107 GAS. WE SUGGEST A COMPLETE PRICE FREEZE BE IMPOSED ON ALL NEW GAS CONTRACTS WHICH ARE IN FORCE ON DATE OF ENACTMENT OF S. 615, IF THOSE PRICES ARE HIGHER THAN THE ESTABLISHED GAS CAP. PRICES SHOULD REMAIN FROZEN UNTIL THE "GAS CAP" (SECTION 301 OF S.615) PRICE REACHES THAT CONTRACT PRICE LEVEL. INDEFINITE PRICE ESCALATORS IN THE CONTROLLED MARKET PROVIDED IN THE NGPA ARE NOW CAUSING PRICE DISTORTIONS, THEREFORE, THIS ELEMENT OF THE CONTROLLED MARKET COULD BE IMMEDIATELY ELIMINATED THROUGH THE PRICE FREEZE. THIS WOULD PREVENT ANY POSSIBILE INABILITY OF PRODUCERS TO MEET ANY PREVIOUSLY AGREED FINANCIAL COMMITMENT.

SIMPLY STATED, WE SUGGEST THAT THE LANGUAGE OF THE BILL STATE THAT THE PRODUCER WILL COLLECT EITHER THE HIGHER OF NGPA 102 OR 103 GAS PRICE OR THE "GAS CAP" PRICE, WHICHEVER IS HIGHER.

☐ HISTORICALLY, THE PETROLEUM INDUSTRY HAS EFFECTIVELY RESPONDED TO PRICE INCENTIVES PROVIDED IN THE ENVIRONMENT OF THE CONTROLLED NATURAL GAS MARKET. LAIPRO BELIEVES IT WOULD BE

MOST ADVANTAGEOUS TO THE CONSUMER TO ALLOW AN INCENTIVE PRICE TO PRODUCERS FOR "NEW" EXPLORATION AND PRODUCTION OF ALL GAS FOUND AFTER DATE OF ENACTMENT OF THIS LEGISLATION.

☐ WE HAVE POUNDED THE TABLE TIME AND TIME AGAIN FOR DECONTROL OF NATURAL GAS PRICES. HOWEVER, THIS BILL GIVES ONLY 1/2 OF THE MARKET CLEARING PRICE. FOR INSTANCE, WHEN THE MARKET PRICES GO DOWN - OUR PRICE GOES DOWN. ON THE OTHER HAND, WHEN PRICES IN THE MARKET INCREASE, OUR PRICE IS FROZEN. FROM THE CONSUMER STANDPOINT THE PRICE AT WHICH GAS SELLS FOR IS THE MARKET CLEARING PRICE.

IN REALITY, MR. CHAIRMAN, THE CONCEPT IS WRONG. TO SET A GAS CAP ON NATURAL GAS PRICES TOO LOW AND WHICH WILL NOT ATTRACT NEED DOLLARS TO DOEMESTIC DRILLING WILL BE A DISSERVICE TO THE CONSUMER.

☐ THE "GAS CAP" (SECTION 301) IS TOO RESTRICTIVE AND AS MENTIONED EARLIER, IT IS OUR OPINION THAT THE ELEMENTS FOR CALCULATING THE CAP SHOULD AVOID ANY ROLLBACK OF THE PRICE OF EXISTING GAS CONTRACTS ON DATE OF ENACTMENT. TO EFFECT THIS WE SUGGEST THAT RENEGOTIATED OR AMENDED CONTRACTS NOT BE INCLUDED IN DETERMINING AND CALCULATING THE GAS CAP.

☐ THE "CONSUMER PROTECTION" PROVISIONS INVOLVING PRICE LIMITS ON PURCHASED NATURAL GAS TO MEET CUSTOMER DEMANDS ARE TOO NARROW AND TOO RESTRICTIVE. WE THINK THERE SHOULD BE A BUILT-IN MECHANISM TO TEST TRUE MARKET PRICING CONDITIONS IN THE

MARKETPLACE PRIOR TO DECONTROL. TO ASSURE THE CONSUMER IS PROTECTED DURING THIS TRANSITION PERIOD, A PHASED IN PASSTHROUGH SHOULD BE CONSIDERED.

☐ THE PROPOSED LEGISLATION ASKS PRODUCERS TO ACCEPT A ONE YEAR EXTENTION OF BOTH DIRECT AND INDIRECT CONTROLS BEYOND THE DATES IN THE EXISTING NATURAL GAS POLICY ACT OF 1978 -- ANY EFFORTS BY CONGRESS TO EXTEND THOSE DATES BEYOND JANUARY 1, 1986 WOULD NOT BE ACCEPTABLE BY LAIPRO OR THE REST OF THE INDEPENDENT OIL AND GAS INDUSTRY. TERMINATION OF THIS TRANSITION PERIOD IS AN INTEGRAL PART OF THE PROPOSED LEGISLATION AND IS SUCH A VITAL ELEMENT TO THE SECURITY OF THE NATURAL GAS INDUSTRY AND THE NATION.

MR. CHAIRMAN, LAIPRO EARNESTLY FEELS THAT THIS PROPOSED LEGISLATION HAS MERIT AND CAN BE THE CORNERSTONE OF BUILDING A SOUND AND REASONABLE ROUTE TO TOTAL DECONTROL OF THE NATURAL GAS INDUSTRY IN 1986. WE ARE WILLING AND READY TO ASSIST THIS COMMITTEE AND OTHERS IN CONGRESS TO ASSURE PASSAGE OF WORKABLE LEGISLATION THAT WOULD LIMIT AND END REGULATORY INTERFERENCE IN THE MARKETPLACE.

FINALLY, MR. CHAIRMAN, I HAVE A STATEMENT WITH AN ACCOMPANYING "LOUISIANA NATURAL GAS PROFILE" PREPARED BY THE LOUISIANA PUBLIC ISSUES AND CONSUMER AFFAIRS COMMITTEE (PICA). THIS COMMITTEE, OF WHICH LAIPRO IS AN ACTIVE PARTICIPANT, IS COMPRISED OF MAJOR OIL COMPANIES, INDEPENDENT OIL AND GAS COMPANIES, PIPELINES, END USERS, CHAMBERS OF COMMERCE, THE LOUISIANA ASSOCIATION OF BUSINESS AND INDUSTRY AND THE LOUISIANA CHEMICAL ASSOCIATION.

PICA ASKS THAT THE STATEMENT BE MADE A PART OF THE RECORD OF THIS HEARING IN CONJUNCTION WITH LAIPRO'S TESTIMONY.

I WILL BE HAPPY TO ANSWER ANY QUESTIONS YOU MAY HAVE FOLLOWING THE PRESENTATION OF THE PANEL. THANK YOU MR. CHAIRMAN FOR THE OPPORTUNITY FOR LAIPRO TO EXPRESS OUR VIEWS TODAY.

PICA

LOUISIANA PUBLIC INFORMATION AND CONSUMER AFFAIRS COMMITTEE
In support of phased deregulation of natural gas

March 8, 1983

The Honorable James A. McClure, Chairman
Senate Committee on Energy and Natural Resources
3104 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman McClure:

We are pleased to have this opportunity to present the following as a statement of the Public Information and Consumer Affairs Committee of Louisiana on the matter of natural gas deregulation which is now pending before your committee.

The Public Information and Consumer Affairs Committee of Louisiana, a broad-based coalition of supplier and consumer groups, has supported and continues to support the concept of deregulation of natural gas price and supply.

Because Louisiana's role as a consumer state is generally less understood, we would like first to address that point. While Louisiana is one of the nation's leading natural gas producing states, it is also, in per capita consumption, the nation's leading natural gas consuming state.

Approximately 62 percent of all gas consumed in Louisiana is used by industry, particularly in the large industrial complex that has developed along the Mississippi River between Baton Rouge and New Orleans. This complex manufactures approximately one third of the nation's petrochemicals and petrochemical products, which are extremely vital to America's agricultural, construction, automobile manufacturing, pharmaceutical, textile and numerous other industries that produce consumer products used by all Americans.

Ninety-five percent of the electricity generated in Louisiana is also generated by natural gas.

Because of the regional disparities created by the Natural Gas Policy Act of 1978, Louisiana's natural gas costs are 14 percent higher than the national average. Since the passage of the NGPA, Louisiana gas costs have risen dramatically. They rose 148 percent between 1979 and 1981 and, during the first eight months of 1982, some residential consumers saw a 35 percent increase.

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The Honorable James A. McClure, Chairman
Senate Committee on Energy and Natural Resources
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Most of the natural gas produced in Louisiana and in the federal waters offshore is exported to other states. At the same time, there have been periods when gas, even in a major producing state such as Louisiana, has been in short supply, forcing Louisiana users to import gas, even from abroad. As the economy begins its recovery, we may again face shortages in Louisiana and the nation.

Since passage of the Natural Gas Policy Act, natural gas exploration and production have failed to keep pace with the nation's long-term needs. More important in the long run, known reserves of natural gas have declined to a dangerously low level in Louisiana.

We believe that the Administration proposal addresses many of these problems in a very positive way. We are encouraged by elements of the legislation that eliminate regional disparities in supply and price. Equal access to all natural gas supplies certainly eliminates one glaring deficiency in existing law. We are also certain that those aspects of the program which require fine tuning will be adequately addressed during the legislative process and will further enhance the provisions which eliminate regional disparities and insure long-term supplies.

Return to a free and competitive market no later than January 1, 1986 will provide stability and incentive to search for supplies of natural gas needed to shore up the nation's declining reserves. Any extension of controls beyond that date is unacceptable

It also provides a return to price stability and long-term supply security for those households and businesses that are dependent upon natural gas. In addition, repeal of the Fuel Use Act will remove artificial restraints on natural gas use in industry and will stimulate more competition between energy sources.

We believe that natural gas decontrol will be, as oil price decontrol has been, in the best interest of consumers in Louisiana and the nation.

We are also submitting the attached "Louisiana Natural Gas Profile" which we would appreciate your incorporating into the record of these proceedings.

Sincerely yours,

John R. Wright

John R. Wright
PICA Committee Coordinator

JRW:grs
Attachment

LOUISIANA NATURAL GAS PROFILE

The data in this profile, if placed in proper perspective, can provide a better understanding of the natural gas situation in Louisiana and the need for removal of federal controls on access to all natural gas supplies, their use and transportation, and phased decontrol of all natural gas prices at the wellhead. The Natural Gas Policy Act (NGPA) and the Natural Gas Act (NGA) should be amended to deregulate wellhead sales, not only as to price controls, but also as to those controls which allocate gas to a particular pipeline or to a particular market, abandonment requirements, rights of first refusal, minimum contract duration, and preferential access to the Outer Continental Shelf (OCS) gas and excess gas supplies in other states.

Natural gas continues to be the primary source of energy which fuels Louisiana's homes, industries and power plants. Total gas consumption for 1981, along with weighted average costs, was as follows:

SECTOR	GAS, BCF	$/MCF	PERCENT
Residential	72	4.17	5.4
Commercial	34	3.88	2.6
Industrial	815	3.26	61.3
Electrical	409	2.68	30.7
	1,330	$3.15	100.0

Given that natural gas is used for approximately 85 percent of the electricity generation, natural gas provides 61 percent of Louisiana's total energy needs. Residential consumption (directly or indirectly from electricity) accounts for almost 14 percent of the gas used in the state, and the commercial-industrial sector accounts for 82 percent. Louisiana's industries depend on natural gas for about three-fourths of their energy, including 187 BCF used as feedstock. (This does not include the gas used in electricity generation, which electricity is a feedstock for the production of such products as chlorine.) Clearly, a reliable, long-term supply of natural gas is necessary for the survival of the state's economic base.

A dependable supply, and provision for increased supplies of natural gas to meet future needs, can best be assured by the phased decontrol of all natural gas prices and freedom from other controls. Studies show that, compared with the situation under current law, full decontrol by January 1, 1985, could increase total U. S. natural gas production by around two trillion cubic feet a year – the equivalent of about one million barrels of oil a day – by 1985.

In addition to greater assurance of adequate long-term supplies for home and industrial users, freeing the wellhead prices of all gas would offer other advantages to the nation. Among them:

- Increased potential under decontrol for the development of natural gas, oil and coal reserves;
- The possibility of reduced oil and natural gas imports, which can be of uncertain reliability, with a possible consequent reduction of costs;
- National security benefits for the country, including a greater degree of U. S. energy independence.
- The possibility that deregulation of price will not have the effect of raising prices, as have been forecast by some. More likely it would stablize or reduce prices, particularly in Louisiana.

ENERGY CONSUMPTION IN LOUISIANA

Louisiana has doubled its consumption of natural gas in the past two decades and now ranks third in the nation in the use of that fuel. It ranks first in per capita natural gas consumption, some 25 percent above the second-placed state – Texas, and industrial consumption is ten times the national average. Louisiana ranks seventh in total energy consumption, although Louisiana ranks 18th in population.

Recent figures published by the U. S. Department of Energy show that about 61 percent of all the energy used in Louisiana comes from natural gas. Petroleum products provide a little less than 40 percent , and coal contributes a small fraction of one percent.

Natural gas consumption in 1981 amounted to over 1.3 trillion cubic feet, including non-utility sales. That represented nine percent of the nation's total gas use.

There were 1,012,000 residential gas customers in Louisiana in 1981. Total residential natural gas consumption was 72 BCF, or an average of about 75 MCF per home. The average residential consumption was over 25 percent less than the national average of 108 MCF. Yet, the average price of that gas was 14 percent higher – $4.17 per MCF in Louisiana vs. $3.68 per MCF on the national average.

During 1981, Louisiana commercial consumers used approximately 34 BCF of gas at an average purchase price of $3.88 per MCF. Nationally, the average price paid by commercial customers was $3.42 per MCF.

Louisiana's industries accounted for 61 percent of the total gas consumed in Louisiana for 1981. These industries were supplied as indicated below:

SUPPLIER	GAS, BCF	PRICE, $/MCF	PERCENT
Intrastate	615	3.36	75
Interstate	83	3.29	10
Distributors	49	3.64	6
Producers	68	1.99	9
TOTAL	815	3.25	100

Of the total 815 BCF consumed, about 39 percent was burned as a boiler fuel. Feedstock, which requires natural gas as a fuel because of its particular chemical properties which are needed in order to create an end product, rose to 23 percent from 17 percent in 1980. About 12 percent was used as process fuel, where natural gas is the most technically feasible fuel available due to its precise temperature controls and flame characteristics. The remainder of the gas was burned either as non-boiler fuel or for plant protection. Almost 92 percent of industrial consumption was supplied either directly or indirectly from intrastate pipelines, at an average cost of $3.43 per MCF.

The leading consumer of natural gas in Louisiana in 1981 was the chemical industry, accounting for almost 79 percent of the gas consumed by industry. Petroleum refining consumed 6.9 percent of the total gas, while the manufacturing of primary metals and paper products can be credited with over five percent.

For the four consuming categories, an analysis of the average price for natural gas in Louisiana shows the tremendous increase in prices since 1979 – all appearing to be NGPA-induced.

SECTOR	1979	1980	1981
Residential	$2.70	$3.42	$4.17
Commercial	$2.37	$2.96	$3.88
Industrial	$0.92	$2.46	$3.26
Utility	$1.54	$2.02	$2.68
TOTAL	$1.27	$2.39	$3.15

The percentage increases between the various years, for average Louisiana prices by sector, are:

SECTOR	1979-1980	1980-1981	1979-1981
Residential	27%	22%	54%
Commercial	25%	31%	64%
Industrial	167%	33%	254%
Utility	31%	33%	74%
TOTAL	88%	32%	148%

When compared to the national averages of *delivered* gas, the above figures show the dramatic effect of the NGPA on Louisiana prices as compared to the national figures.

SECTOR	1979	1981
Residential	$2.97	$3.68
Commercial	$2.77	$3.42
Industrial	$1.99	
Utility	$1.80	
TOTAL	$2.33	

The major energy source for the generation of electricity in Louisiana is natural gas. This gas is usually burned as a boiler fuel, changing water into a steam. This steam is then injected under high pressure into a turbine, thus creating electricity. Natural gas and fuel oil consumption by the electric sector in Louisiana for 1981, as well as electricity generated, have been estimated as follows:

GAS, BCF	OIL, MB	GEN., BKWH
409.26	4,531.96	43.7

These facts illustrate the importance of dependable, long-term natural gas supplies to Louisiana's economy, and particularly to the state's industrial base.

LOUISIANA'S STAKE IN NATURAL GAS DECONTROL

Congress has the opportunity now to change natural gas legislation that is working against the best interests of Louisiana.

Federal controls on the wellhead price of gas and arbitrary restrictions on the industrial use of gas are creating serious problems for Louisiana. Those same controls also restrict Louisiana's access to gas supplies in the OCS and other states.

The best approach is to remove wellhead price controls gradually, with all categories of natural gas to be free of government ceilings by January 1, 1985. Phasing out controls in that way will allow consumers time to adjust to the change and will stimulate the discovery and production of additional domestic gas supplies.

Historical Background

A review of the facts may help to explain how the current situation developed.

The Natural Gas Act passed in 1938 brought interstate gas pipelines under federal control but did not control the wellhead prices paid to producers in the field. In 1954 the U. S. Supreme Court interpreted that law and assigned to the Federal Power Commission the task of setting wellhead prices of all sales of natural gas for resale in interstate commerce.

Until 1978, however, natural gas produced and used within a single state, such as Louisiana, remained free of government price controls. That freedom encouraged producers to search for new gas reserves. The abundant supplies that resulted made it possible for Louisiana's economy to prosper. The state attracted industries whose operations depend upon secure, uninterrupted supplies of natural gas. That growth created jobs, increased state revenues and raised the standard of living for the citizens of Louisiana.

In the interstate market, meanwhile, government price controls led to serious problems. The effect of price controls on natural gas was predictably the same as price controls on other products – reduction of supply. Over a period of years, U. S. proved reserves of gas dropped by one-third. Production sagged, and as early as the 1960's, spot shortages began to appear in some parts of the nation during peak demand periods. Severe gas shortages in 1976-77 forced numerous schools and factories to close.

After a long struggle to find a better approach to the nation's gas problems, the NGPA was passed. Its supporters said the new law would correct the flaws in U. S. gas policies, but in many ways it worsened the situation.

For the first time, the new law extended federal control of wellhead prices to all gas produced anywhere in this country. Today's controls apply not only to the interstate market, but also to gas produced and used within states – the intrastate market.

The law also set up an enormously complex pricing scheme with over 20 categories of gas, each with its own price and its own set of rules. The NGPA provides that about half of the nation's gas production will be decontrolled in 1985. But the other half will remain under controls until those supplies are exhausted. It is the half which will remain under control that will serve to create further disparities in the intrastate market.

To date, "deep" gas (Section 107) is the only decontrolled category from which significant production is coming. That is high-cost gas from wells that penetrate 15,000 feet or more into the earth. "Deep" gas represents only about three percent of current U. S. production; however, the search for "deep" gas in Louisiana is a significant activity.

Problems Created by the NGPA

Congress intended the NGPA to increase the prices of certain types of gas gradually, so that when those supplies are decontrolled on January 1, 1985, their prices would be about the same as the price of crude oil. Congress estimated that the price of crude at the beginning of 1985 would be around $15 a barrel in 1978 dollars, and they wrote the law accordingly.

But Congress did not anticipate that world crude oil prices would double in 1979 and 1980 in the wake of the Iranian revolution. Today, world oil sells for more than $30 a barrel. Thus, events already have caused world oil prices to leave the NGPA timetable for gas prices far behind. By the end of 1984, there could be a large gap between world oil prices and the prices of the gas that is to be decontrolled on the following day. If so, the prices of about half of the nation's gas supplies could increase suddenly and sharply, again to the serious disadvantage of the intrastate market and those consumers dependent upon those deregulated gas supplies.

How NGPA's Disparities Affect Louisiana

Louisiana's consumption demands make it clear that adequate supplies of natural gas are important to every segment of the state's economy. It also underscores that future growth – economic survival – is in jeopardy under current conditions.

In Louisiana and across the nation, an increasing share of recent drilling efforts have been directed toward searching for oil, which is free of government controls, rather than for price-controlled natural gas. Continuation of this trend will pose a threat to the adequacy of future gas supplies for those who depend on gas from Louisiana. Additionally, a significant share of the new onshore drilling efforts in Louisiana have been directed toward the decontrolled "deep" gas, making it more costly for Louisiana consumers who are forced to buy the more expensive gas when the less expensive gas supplies are not available.

The problem is worsened by the fact that some interstate pipelines have a "cushion" of low-priced gas which allows the more expensive "deep" gas costs to be "rolled in," thus lessening the impact of higher gas costs. The intrastate pipelines, on which Louisiana largely depends, have a substantially smaller "cushion." Additionally, the interstate "cushion" allows the "bidding up" of gas prices, making the price out of reach for the intrastate companies. In reality, the "cushion" drives up prices for all consumers.

Louisiana experienced shortages in deliverability in 1981 which have been temporarily relieved by decreased consumption due to recession and increased supplies through interruptable interstate purchases. Before industrial production/consumption declines caused by the stalled economy, it was anticipated that Louisiana supplies would be approximately 35 percent deficient in 1983 and as much as 50 percent deficient in 1985. When the business economy resumes more normal production/consumption levels the shortfall could become severe.

This shortfall situation could be relieved, in part, by allowing Louisiana access to OCS gas and excess supplies in other states.

According to the NGPA, one of the definitions of natural gas which is committed or dedicated to interstate commerce is "Natural Gas which is from the Outer Continental Shelf." Many intrastate companies and potential end-users of natural gas have expressed an interest in purchasing gas from the OCS; however, continued rigid interpretation of this definition by the regulatory authorities has prevented intrastate pipelines and consumers from obtaining this gas, either for system supply or end-use. As an example, one large chemical company has part interest in gas production in the OCS off the Texas coast but cannot get FERC approval to have this gas transportated for its own use in Texas. Similar situations exist with several Louisiana-based companies.

Access to and transportation of intrastate gas across state lines for intrastate companies or end-users presents several problems. Section 311, the self-implementing rule of NGPA, does not specifically cover transportation of this intrastate gas from one state to another. Recent rulings by FERC have not completely clarified whether the interstate transporter must seek FERC approval or can rely on the self-implementation feature of Section 311. Regardless, the latter is good for only two years, with a provision for extension. In addition, interstate pipelines have no incentive to transport for others, as they are allowed to keep only one cent per MCF of any transportation fee.

Several chemical companies in Louisiana have contacted intrastate gas companies in Oklahoma over the past few years in an effort to secure surplus gas. Until recently, when greater excess supplies were experienced, none of these companies showed any interest in selling to Louisiana consumers, as the regulatory requirements were too severe. Repeal of laws and regulations that inhibit or prevent interstate pipelines from transportating gas for intrastate gas companies or end-users across state lines is imperative.

The disparity in the marketplace between intrastate and interstate pipelines is most marked in the area of very low-priced, permanently controlled volumes which appear to set a cushion to offset the purchase of higher-cost gas. As previously mentioned, intrastate pipelines traditionally have smaller cushions of this low-priced gas available and, together with the purchase of higher-cost gas, the average unit price paid by intrastate pipelines is higher than for interstate pipelines. The offset of the cushion and higher-cost gas, resulting in the same average price to the consumer, has not proven to work from the historical perspective and cannot be said to provide a workable model upon deregulation.

As these "cushions" of low-priced gas reserves are depleted, producers who have inadequate incentives to develop replacement supplies will be unable to renew these contracts, and the intrastate market will have to find alternate supplies to replace this cushion, resulting in higher prices for the consumer. Of immediate concern is the expiration of certain low-priced contracts to two major utility companies in the state. Replacement supplies will be much more expensive, as has been proven in the new purchases by industrial firms who have already experienced the expiration of low-priced contracts.

In 1985, the situation becomes even worse. Less interstate gas will be decontrolled than in the intrastate market. Interstate pipelines will have a substantially larger cushion than intrastates. Generally speaking, all pipelines will have to do whatever necessary to supply their customers. Intrastates will be competing with the interstates for decontrolled gas to satisfy their market requirements, and again the result will be higher prices for the consumer. Yet, as stated in the EIA report of June 1982, three times as much intrastate gas than interstate gas supplies will be deregulated in 1985. The disparity indeed worsens the intrastates' positions.

Thus, it is evident that the survival of the intrastate gas system is threatened, because the intrastate pipelines cannot compete on equal terms for new gas supply with the interstate pipelines. As the interstate pipelines tie up more and more gas supply, not only new supply, but gas formerly sold to intrastate pipelines, the intrastate pipelines have difficulty in meeting their customers' needs for a firm, reliable gas supply at an economical cost. Intrastate pipelines, and their customers, are forced to look to the surplus on the interstate system as a temporary and interruptible supply to make up for the fact that the intrastate pipelines cannot average in cheap price-controlled gas with the artificially high prices (as induced by the NGPA) and still yield an acceptable rolled-in price. But, neither the intrastate pipelines nor their customers can rely on an interruptible supply of gas, and as this supply becomes inadequate or unavailable the intrastate systems will not be able to meet their customers' needs. It can only be considered a short-term, stop-gap measure.

The NGPA creates the low-priced gas cushion, and the non-regulated gas will continue to draw premium prices. As a result, the pipelines with the cushion of low-priced gas will be able to pay higher-than-market-level prices and average those prices into the low-priced "cushion," thus achieving a market selling price that is lower than that of intrastate pipelines who have a much smaller volume of low-priced "cushion" gas in their total supplies.

The disparities of the NGPA, as mentioned, must be addressed. Yet, they must be addressed with the realization that a long-term energy policy must be established, rather than a short-sighted, stop-gap effort. Most petrochemical plants which have American and Louisiana operations are operated by multi-national companies which compete on an international basis. These companies, although having tremendous capital investments in the United States, are being attracted to foreign countries because of the price and availability of natural gas supplies. The cost of energy is such a major cost of production that it pales the capital already invested in America. Thus, the ease of transporting petrochemical products versus the transporting of LNG; the offer of capital subsidies by foreign nations for plant locations; the lower-priced natural gas; and the potential for profit are attractive to companies which are otherwise facing the potential of economic doom as a result of American energy policies. The result? Loss of American jobs to foreign countries. Wasted capital investment in America. A negative balance of payments as imports increase. The potential for economic warfare with key defense-related materials.

As a case study, the fertilizer industry presents an example of the problems faced by Louisiana's petrochemical industry. The nitrogenous fertilizer industry is a significant part of Louisiana's economy. The 26 major nitrogenous production facilities located in the state represent an investment of in excess of $1.6 billion, employ more than 1,700 workers, and generate a payroll of around $51 million annually. The presence of the industry extends to all parts of the state. In total, the industry directly affects 17 of the state's parishes.

In addition to this direct presence, the industry also has a significant indirect presence in the state. Combined, the Louisiana fertilizer industry accounts for in excess of 13 percent of the entire quantity of gas consumed in the state. Consequently, the fertilizer industry represents an extremely significant and economically necessary market both for Louisiana's gas pipelines and, in turn, its natural gas producing industry.

Finally, it should be noted that the industry is important not only to Louisiana and the Louisiana farmer, but also to the nation as a whole. With over 30 percent of this country's domestic nitrogenous fertilizer capacity located in Louisiana, any actions which affect the Louisiana segment of the industry will have far-reaching, national repercussions.

The nitrogenous fertilizer industry is one heavily dependent on natural gas. Indeed, in the majority of the state's plants, gas costs alone accounted for in excess of 83 percent of total production costs in 1981. As a consequence, the cost of natural gas is the preeminent determinant in the economic viability of the Louisiana industry.

In substantial part because of the severely disruptive effects which the Natural Gas Policy Act of 1978 is having on the cost of natural gas to Louisiana consumers, Louisiana fertilizer plants are becoming increasingly less competitive. Although the gas consumed by these plants is among the least taxed in the nation, by the end of 1981, the majority of Louisiana fertilizer producers were paying an average delivered price for their gas from 20 to 30 percent higher than that paid by plants located in Oklahoma (the state with the next highest concentration of nitrogenous plants) and 14 percent higher than that paid in Arkansas, one of its other major regional competitors. With such a cost disadvantage, the Louisiana plants have become the most marginal (or, put another way, expendable) of any in the domestic fertilizer industry.

Because Louisiana's competition has low, subsidized gas prices, the Louisiana industry is also becoming increasingly sensitive to competition from nitrogenous fertilizer imported into the United States from Mexico, Venezuela, Trinidad and, to an ever-increasing extent, the Soviet Union. In 1981, increases in gas costs pushed the average cost of producing fertilizer (exclusive of profit) for most of Louisiana's plants to around $153 per ton. Continuing increases are projected to drive that cost to around $170 per ton by the end of 1982. To earn a sufficient return to encourage continued operations requires, at a minimum, an additional $10 to $15 per ton.

Recent industry data suggest, on the other hand, that the average "landed" (F.O.B.) price for fertilizer imported into the Louisiana Gulf Coast currently is selling for as low as $145 per ton, or from $18 to $23 cheaper than Louisiana production. With substantial increases in the productive capacity of foreign manufacturers expected to occur in the very near future, the likelihood exists that they will be able to export ever-increasing amounts of fertilizer into the United States in the years ahead. It is reasonable to expect that such increases will serve primarily to displace marginal domestic production.

Thus, the current outlook for the Louisiana nitrogenous fertilizer industry is not good. Increasing gas costs are already rendering the Louisiana industry increasingly noncompetitive relative to other domestic production. The same underlying cause similarly is affecting the competitive position of other Louisiana industries relative to imports.

The United States cannot exist as a consuming nation, with production being centered in other countries. Louisiana will be the first state to experience the collapse of its economic base, and other states which depend on the products of Louisiana's petrochemical industry will soon follow.

SUPPLY

Louisiana is one of the three leading states in the production of natural gas and crude oil. Here is how the state ranks, according to figures published by the U. S. Department of Energy:

- No. 2 in natural gas production in 1981; Louisiana's nearly 6.7 trillion cubic feet of gas represented over one-third of all the gas produced in the United States.
- No. 2 in proved gas reserves as of 1981; Louisiana's 47.4 trillion cubic feet represented almost one-fourth of the nation's total.

- No. 1 in gas exported to other states in 1980; Louisiana provided more than 4.8 trillion cubic feet for shipment to other parts of the nation. That represented 73 percent of the state's natural gas production (onshore and OCS).
- No. 3 in crude oil production in 1981; Louisiana's 382 million barrels represented about 13 percent of the nation's total oil output.
- No. 4 in proved oil reserves as of 1981; Louisiana's 3.0 billion barrels represented more than 10 percent of the U. S. total.
- No. 2 in natural gas liquids proved reserves as of 1981; Louisiana's 1.3 billion barrels represented 19 percent of the nation's total.
- No. 2 in natural gas liquids plant production in 1981; Louisiana's 105 million barrels represented 18 percent of the U. S. total.
- No. 7 in both producing gas wells (12,763) and producing oil wells (25,320) at the end of 1981; Louisiana has nearly 7 percent of the nation's gas wells and more than 4.5 percent of the U. S. oil wells.

Louisiana began producing oil in 1902 and natural gas in 1905. Since then, through 1981, the state is estimated to have produced more than 21 billion barrels of crude oil, nearly 165 trillion cubic feet of natural gas, and more than 1.5 billion barrels of natural gas liquids. All 64 parishes in Louisiana produce oil or gas, or both.

From the beginning of production until the end of 1981, drilling in Louisiana resulted in approximately 72,700 oil wells, 25,500 natural gas wells and 58,300 dry holes.

In 1981 alone, 5,379 wells were drilled in Louisiana. Of those, 1,678 were gas wells, 1,635 were oil wells and 2,066 were dry holes.

DRILLING, RESERVES AND PRODUCTION FIGURES FOR LOUISIANA

(include operations on state and federal offshore leases in the adjacent Gulf of Mexico as well as onshore activities)

Natural Gas Production, 1981 (Billion cubic feet)

Louisiana	6,692
United States	18,737

Natural Gas Proved Reserves, 1981 (Billion cubic feet)

Louisiana	47,377
United States	201,730

Crude Oil Production, 1981 (Million barrels)

Louisiana	382
United States	2,949

Crude Oil Proved Reserves, 1981 (Million barrels)

Louisiana	2,985
United States	29,426

Natural Gas Liquids Plant Production, 1981 (Million barrels)

Louisiana	105
United States	580

Natural Gas Liquids Proved Reserves, 1981 (Million barrels)

Louisiana	1,327
United States	7,068

Producing Gas Wells, 1981

Louisiana	12,763
United States	189,609

Producing Oil Wells, 1981

Louisiana	24,320
United States	557,009

The annual rate of increase in the number of natural gas wells drilled has slowed considerably since the passage of the NGPA, and a dramatic decline in drilling of all kinds has been observed during the Summer of 1982. Now that oil is free of government price controls, a larger share of the drilling effort is being directed toward the search for oil, rather than gas.

The number of oil wells drilled in the United States was 112 percent higher in 1981 than in 1978. In the same years, the number of gas wells drilled rose by only 37 percent. In Louisiana, the number of oil wells drilled in 1981 was 85 percent higher than in 1978. In the same period, Louisiana gas wells drilled increased by only 30 percent. Additionally, as of September 1, 1982, the number of rotary rigs operating in Louisiana declined to 271 from a high of 473 at the end of 1981.

The significance of the decline in rotary rig operations is that the recovery period—in which the decline in petroleum reserves was slowed — ended in 1982. While national net reserves of natural gas declined by 2,076 BCF, it is important to note that Louisiana reserves dropped by 2,807 BCF. All declines in the nation's reserves are thus seen occurring in Louisiana. Louisiana reserves are not being replaced as fast as production, and they are being replaced at a lesser volume than in other producing states.*

Drilling for natural gas in the Gulf Coast region must continue at a high rate if sufficient supplies are to be found and developed to meet the needs of Louisianans and residents of other states who private agencies indicate that development in this region will play a vital role in future United States oil and natural gas production. The Colorado School of Mines estimated in 1981 that an area including Louisiana, Arkansas, northeastern Texas and the waters off the Louisiana coast had a natural gas potential of 132 trillion cubic feet.

The U. S. Geological Survey published a range of estimates of undiscovered recoverable U. S. oil and natural gas resources in 1981. The high end of that range indicated that the onshore and offshore areas along the Gulf Coast may contain as much as 23.7 billion barrels of crude oil and 363 trillion cubic feet of natural gas. Those figures represent 23 percent of the nationwide total for oil and 49 percent of the natural gas. The mid-range estimates indicated that the Gulf Coast region may contain about 17 percent of the nation's oil and 33 percent of the gas yet to be found.

The areas covered by those Geological Survey estimates include all of Louisiana, portions of Texas, Arkansas, Mississippi, Alabama and Florida, and the waters of the Gulf of Mexico out to a depth of 2,500 meters.

These studies make it clear that although the Gulf Coast region has been producing oil and natural gas for many years, scientists believe a great deal more can still be found and produced.

**Figures used represent unadjusted figures. Adjusted figures will show near equilibrium between new reserve additions and consumption.*

Continued drilling is necessary because every oil and gas reservoir eventually becomes depleted and must be replaced by new sources of supply. Natural gas production in Louisiana, the adjacent waters of the Gulf of Mexico and the OCS reached a peak of 8.2 trillion cubic feet in 1973.

The necessity of continued investment and drilling efforts to maximize production is shown in the reserve to production ratios in south Louisiana. From 1970 to 1976, onshore Louisiana production declined by 37 percent, and proved reserves declined by 49 percent. From 1977 to 1980, production dropped by an additional 18 percent and proved reserves declined by 26 percent.

Many economists, academicians and petroleum analysts believe the NGPA is discouraging investment in the search for new gas supplies and that it is particularly harmful in that it is directing drilling efforts away from gas that might be found at relatively shallow depths at moderate costs.

Twenty-eight years of governmental regulation of price, supply and use of one third of our nation's domestic energy production, while leaving unregulated the other two thirds, has produced major economic distortions, dislocations and disorders that are obvious and undoubtedly even more that are less obvious. They have been and are today very costly to our state's and nation's economy and have been a major obstacle to the development of a sound national energy policy and rapid movement toward energy independence.

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The CHAIRMAN. Mr. Walzel.

STATEMENT OF JAMES V. WALZEL, PRESIDENT, HOUSTON PIPE LINE CO., ACCOMPANIED BY RICHARD ALSOP, GENERAL COUNSEL

Mr. WALZEL. Gentlemen, my name is Jim Walzel. I am the president of the Houston Pipe Line Co.

Our general counsel, Richard Alsop, is here with me today.

We appreciate this invitation to be here to testify and we hope that we can offer somthing constructive that will be useful to you as you start to work on this gas legislation.

We have made some specific suggestions in our testimony, and I am just going to make a few brief comments, if I can, about the bill and about the gas business in general.

Our company, Houston Pipe Line is part of the Houston Natural Gas Corp. In terms of the amount of natural gas that we handle each day, we think we are the biggest intrastate pipeline company in the United States, and in terms of direct sales to industrial customers, we sell more industrial gas than any other pipeline company, interstate or intrastate.

My own experience in the gas business over the last 15 years has been primarily working on gas contracts, to buy gas from producers out at one end of our pipeline, and working on sales contracts at the other end of the line trying sell gas to people.

These have typically been competitive situations, and have operated in a basic free environment type of situation.

Our company has prospered in this environment for the last 50 years, and based on our company's experience and my own experience, we are convinced that a free market will work in natural gas; it has worked in Texas, and it is the right direction for us to moving in.

We think that the administration's proposal is the best thing that we have seen as far as a proposal to try to move from where we are to a free market.

We think that now is the time to do something, and we think that the administration bill contains the three basic features that are necessary to move to a free market.

No. 1, it moves to remove wellhead price controls.

No. 2, it moves to remove restrictions to keep gas from flowing from its sources of supply to the markets where it is needed.

No. 3, it provides a mechanism to unravel a very complicated gas market mess that we have; and still provides consumer protection while we move from where we are to where we need to be.

I know that you have interfaced with some difficult decisions, and I would like to just leave you with two ideas.

One is, I think the gas consumer is the person that you are most concerned with, and that you should be. I believe that if you can do what is best for the gas consumers of this country, that all other segments of the industry will also prosper.

Of course, I think what is best for the consumer is to get to a free market, and that he will be best served in that market, and have the best chance of having adequate supplies at low cost.

The final thing I want to say, and I know many members of this committee were here in 1978, and think it is too soon to go through this gas business again.

But we haven't had that much gas legislation in this country. We have had a Gas Act of 1938; we had another one in 1978.

Basically, what was done in 1978 needed to be done. The Natural Gas Policy Act, I think, was a constructive thing. We are better off that that was done than we would be had it not been done, but there are a lot of problems that have been described, and now is the time—and I think you have the opportunity to move from where we are into a free market, and maybe this will be the last time we will ever have to look at gas legislation. I think that is possible.

Thanks.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Walzel follows:]

Comments By

JAMES V. WALZEL

PRESIDENT

HOUSTON PIPE LINE COMPANY

INTRODUCTION

Mr. Chairman and Members of the Committee, I am Jim Walzel, President of Houston Pipe Line Company, a wholly owned subsidiary of Houston Natural Gas Corporation. I appreciate the opportunity to appear before you today.

Houston Pipe Line owns an intrastate system operating in the Texas Gulf Coast area and, through Houston Natural Gas Corporation, is affiliated with other intrastate pipeline systems which extend into the other major producing areas of Texas and connect with Houston Pipe Line's system.

Today, Houston Pipe Line Company and its affiliated systems operate almost 5,000 miles of natural gas pipelines within the State of Texas. These pipelines originate in the gas producing fields where we compete with numerous other pipeline companies for the acquisition of gas reserves, and extend to gas consuming markets where we compete for sales with many other energy companies, which also supply natural gas and other fuels. Houston Pipe Line delivers for sale or transport about 2.8 Bcf of gas per day and serves industrial consumers directly and about 120 distribution systems at city gates. We are the largest supplier of direct industrial natural gas in the country. Houston Pipe Line and other Texas intrastate pipeline companies supply substantially all of the natural gas fuel and feedstock requirements of the substantial industrial complexes in Texas situated primarily along the

Gulf Coast area as well as the agricultural, commercial and residential consumers in the extensive service area of Texas.

Prior testimony before this Committee, other Congressional committees and the FERC have outlined the size and importance of the Texas intrastate market to the country as a whole, as well as the adverse impact the Natural Gas Policy Act ("NGPA") is having on the intrastate market in general. On August 16, 1982, I submitted written comments to the House Energy and Commerce Committee Sub-Committee on Fossil and Synthetic Fuels describing conditions in the gas industry and the market distortions experienced operating under the NGPA and the Natual Gas Act ("NGA"). Attached and marked "HPL-Exhibit A" is a copy of those comments which remain pertinent to the issues before you today relative to the need for new federal gas legislation and the best approach to achieve adequate supplies of gas at reasonable costs.

THE ADMINISTRATION PROPOSAL

The Administration's Proposal entitled "Natural Gas Consumer Regulatory Reform Amendments of 1983" is the best solution offered to assure adequate supplies of gas at reasonable costs for the future. It would do so by phasing producers out from under utility rate regulation. Imposing governmental utility rate policy on a non-utility industry such as gas exploration was a grievous error which should have been cured 30 years ago shortly after it was established in the celebrated Phillips Case.

The Administration's Proposal would also rescind the unnecessary and counterproductive provisions of the NGA and NGPA which restrict interstate and intrastate pipeline systems from contracting for the transportation of gas from sources of supply to markets. The NGPA partially eliminated the clogs in the pipeline regulatory scheme, and TITLE IV of the Administration's Proposal would complete the task of limiting NGA jurisdiction to interstate pipelines while intrastate pipelines are fully and properly regulated under state law by state regulatory agencies and under Sections 311-314 of the NGPA with respect to transactions involving interstate commerce.

Title I

Since Title I applies only to interstate pipeline companies, Houston Pipe Line will offer no suggestions.

Title II

Title II eliminates the wellhead price controls of the NGA and the NGPA and the last vestiges of certificate and abandonment jurisdiction over first sales of gas under the NGA, both of which will benefit consumers and the gas industry. The operation of Title II will not increase gas costs to consumers since some provisions of the NGPA have already permitted gas costs in the aggregate to reach market clearing levels. It is our belief that Title II will foster the development of the least expensive gas supplies, instead of the high cost supplies such as deep gas and tight sands gas which are products of the NGPA.

Title III

Title III is intended to decontrol all first sales of gas in an orderly manner but requires some revision. These revisions include:

1. New Section 316 attempts to fashion a market out provision which will induce contract pricing renegotiations, but the provision can be more aptly characterized as a termination right. Market out provisions in gas purchase contracts historically have provided procedures under which the parties attempt to negotiate lesser prices. The procedures also provide that producers will not get less than market value by a purchaser willing to buy the gas and that the pipeline will not pay more than it believes it can pay to market the gas. Unless the producer can find a purchaser ready, willing and able to pay more under comparable terms of purchase than the pipeline which invoked the market out provision, the producer should not have a termination right.

   Since the gas supply contract mix of most interstate pipelines is made up primarily of low cost contracts under Section 104 of the NGPA and high priced contracts under Section 107, they and their producers will have incentive to negotiate amendments to existing contracts. Since intrastate pipelines generally had high gas cost contracts containing indefinite pricing provisions on the date of enactment of the NGPA, they have practically no high or low cost contracts which require renegotiation. Therefore, it is unfortunately likely that most intrastate purchase contracts will not be renegotiated and thereby will be subject to termination under the Administration's Proposal. For reasons not necessarily relating to gas contract prices, many intrastate pipelines, and perhaps a large number of interstate pipelines, may well loose substantial gas reserves from their systems.

It is urged that this deficiency be corrected by establishing the procedures above described, and particularly not allowing pipelines to loose gas reserves if they are willing to pay prices per MMBtu equal to the offer a producer has received from another who is ready, willing and able to purchase the producer's gas under terms of purchase comparable to those offered by the pipeline company.

2. New Section 315 establishes an option of purchasers to take only 70% of the deliverability under a contract. This will not give pipelines significantly more flexibility in their take-or-pay obligations since they will be required to take 100% of 70% of the deliverability instead of take-or-pay for about 80% of deliverability. It will merely

provide a means to release gas for purchase by others. After pipelines have exercised this option, they would nonetheless have difficulty operating under the Texas Railroad Commission's ratable take orders which contemplate that each pipeline will take ratably from all producers in a field and from all fields from which the pipeline purchases gas.

The take-or-pay problems which significantly affect only a few pipelines should be left to the negotiation process contemplated in Title III.

3. New Section 111(b) would restrict tight sands gas to the applicable NGPA maximum lawful price until January 1, 1986, even though the gas cap under the Administration's Proposal should be higher. Tight sands gas should be allowed to receive the gas cap price if it is higher.

Title IV

Title IV provides a statutory path along which gas can flow from all sources of supply to all markets. The NGPA, as interpreted by the FERC in Docket No. CP81-99-000, Transwestern Pipeline Company, provides for the transportation of gas purchased from a producer in one state and transported to the purchasing intrastate pipeline in another state under Section 311(a), but when enacted, it failed to contemplate the need for some types of transactions such as reverse Section 311(b) sales and the sale of gas by an intrastate pipeline in one state to an intrastate pipeline in another. The Administration's Proposal adequately covers the different types of transactions, but needs refining to preclude some unintended consequences, as follows:

1. Revised Sections 311(a) (2) (A) and 311(b) are so broad that the FERC might usurp the jurisdiction of the Texas Railroad Commission and other state regulatory agencies over the intrastate transportation and sale of natural gas not being transported or sold under Sections 311(a) and (b), respectively, and not otherwise involving interstate commerce. This is obviously an oversight and should be corrected.

2. To provide clarity, new Section 601(d) (1) should have inserted the term "or transporting" after the word "purchasing" so there can be no doubt that transportation under a covered transaction is exempt from NGA jurisdiction.

3. The new Section 601(e) properly prohibits FERC discriminatory policies relative to the transportation of gas by or for interstate and intrastate pipelines, but it should not cover the sales policies currently being reviewed by the FERC in Docket No. GP82-47-000, Review of Off-System Sales Program. The FERC will establish policies in this proceeding designed to protect the interests of consumers served by interstate pipelines and those

served by intrastate pipeline companies. Strong public interst policies require that the concluding rules from this proceeding should be reflected in Section 601(e).

Under the new Section 317, the Commission may order an interstate pipeline to carry gas from a producer to a purchaser under terms and conditions determined by the FERC to be just and reasonable. It properly covers only interstate pipelines. This type of jurisdiction over intrastate pipeline companies has never been and should not be divested from state regulatory agencies for the reasons recognized during the promulgation of the NGA and the exclusion of intrastate pipelines from FERC's jurisdiction over the incremental pricing provisions of the NGPA. The Texas Supreme Court ruled in the Bayou Pipeline Case, 568 SW2d 122, that the Texas Railroad Commission has this type of jurisdiction under the Cox Act, Tex. Rev. Civ. Stat. Ann. art. 6050, and the Public Utility Regulatory Act, Tex. Rev. Civ. Stat. Ann. art. 1446(c), over Texas intrastate pipeline companies.

OTHER PROPOSALS

Congress may well be deluged with competing drafts of gas legislation from different industry groups, so-called consumer groups and helpful members of Congress. Houston Pipe Line urges this Committee to focus on the Administration's Proposal. Other proposals have offered no unique solutions, but usually attempt either to penalize producers which operates ultimately to the detriment of consumers or attempt to find perfection through comprehensive governmental tinkering with the various segments of the gas industry.

CONCLUSION

If the desires of special interests and of partisan politics will defer to the best interests of the nations's consumers, Congress' enactment of a Bill embracing the principles set forth in the Administration's Proposal will prove to be the best approach to assure adequate supplies of gas at reasonable costs in all markets for the future.

Comments By

JAMES V. WALZEL

PRESIDENT

HOUSTON PIPE LINE COMPANY

Mr. Chairman and Members of the Committee, I am Jim Walzel, President of Houston Pipe Line Company, a wholly owned subsidiary of Houston Natural Gas Corporation. I appreciate the opportunity to appear before you today.

Houston Pipe Line owns an intrastate system operating in the Texas Gulf Coast area and, through Houston Natural Gas Corporation, is affiliated with other intrastate pipeline systems which extend into the other major producing areas of Texas and connect with Houston Pipe Line's system. In 1969 when the potential inadequacy of long term gas supply available to us in the Texas Gulf Coast area started to appear, we participated in the construction and ownership of a 500 mile, 36-inch transmission line to the Delaware and Val Verde Basins in West Texas, and when those supplies started to decline, we constructed several pipeline systems in Texas state waters and, in July of this year, we placed in service a 360 mile, 24-inch pipeline extending into the Anadarko Basin in the Texas Panhandle.

Today, Houston Pipe Line Company and its affiliated systems operate almost 5,000 miles of natural gas pipelines within the State of Texas. These pipelines originate in the gas producing fields where we compete with numerous other pipeline companies for the acquisition of gas reserves, and extend to gas consuming markets where we again compete with many other energy companies, which supply natural gas and other fuels, for sales. Houston Pipe Line delivers for sale or transport about 2.8 BCF of gas per day and serves industrial consumers directly and about 120 distribution systems at city gates. We are the largest supplier of direct industrial natural gas in the country. Houston Pipe Line and other Texas intrastate pipeline companies supply substantially all of the natural gas fuel and feedstock requirements of the vast industrial complexes in Texas situated primarily along the Gulf Coast area as well as the agricultural, commercial and residential consumers in the immense service area of Texas.

Prior testimony before this subcommittee, other Congressional committees and the FERC has outlined the size and importance of the Texas intrastate market to the country as a whole, as well as the adverse impact the NGPA is having on the intrastate market in general.1/ Today, rather than repeat this information, I would prefer to focus on Houston Pipe Line Company's operations under the NGPA and the problems we are experiencing or expect to experience as a major supplier of intrastate natural gas.

I will endeavor to be responsive to the written questions furnished me by you and, of course, I will answer candidly any questions you may have today.

OPERATIONS UNDER THE NATURAL GAS POLICY ACT

Although Houston Pipe Line's operations have not changed dramatically since passage of the NGPA, unless the Act is revised we believe some parts of our operations will likely be adversely affected as the consequences of some of its ill-conceived provisions become more pronounced (Q. No. 1).[2] Until recently the sales volumes of gas of Houston Pipe Line and, I believe, of other Texas intrastate pipeline companies have remained substantially level as the conversion to coal fired boilers has been offset by expanded industrial operations and increased population;[3] however, transportation volumes have notably increased as a result of the NGPA providing a means by which intrastate pipelines can transport gas for interstate pipelines without incurring Natural Gas Act jurisdictional consequences (Q. No. 2).[4] Also, Section 311(b) of the NGPA[5] authorizes intrastate pipelines to sell surplus gas to interstate pipelines without such jurisdictional consequences. Houston Pipe Line has three agreements with interstate pipelines but currently is not making any sales.

Today, intrastate pipelines in Texas are generally experiencing difficulty in maintaining sales volumes because of the depressed economy, accelerated conservation improvements to facilities as gas prices go higher, the increased use of coal-fired boilers to generate electricity, and the increased use of ethane and propane by industrial consumers in refineries and petrochemical plants (Q. No. 2). TENRAC estimates that there is currently 2.5 BCF per day of surplus gas deliverability in Texas, of which 1.5 is intrastate and 1.0 is interstate.6/ This surplus deliverability concerns intrastate pipelines because it has led to the recent intrusion into the intrastate market by interstate pipeline suppliers who have applications pending to dump tremendous volumes of cheaper supplies of gas in the intrastate markets without assuming long term service commitments (Q. No. 2).7/

Because we operated prior to NGPA without wellhead price controls and sold substantial volumes of gas to industrial customers, Houston Pipe Line was concerned with market clearing prices even before the NGPA and considers the primary price which must be observed in purchasing gas and in incurring other operating expenses to be the burner tip price for the Btu equivalent of #6 fuel oil 8/, and we are also cognizant of the prices of competing pipeline companies (Q. No. 6)9/. This industrial market clearing price restriction has served well as a ceiling for domestic consumers, who also have the option of electric power, or liquified petroleum gases in many instances (Q. No. 6).10/

Subject to reasonable governmental regulation, demand for gas on Houston Pipe Line's system should remain relatively constant through 1990, although this projection assumes repeal of the Powerplant and Industrial Fuel Use Act [11] which few now consider wise legislation (Q. No. 16).[12] Houston Pipe Line's gas supplies that will remain under price controls in 1985 will be the portion of 30% of total supplies existing today which have not been produced by 1985 (Q. No. 14). We are concerned whether supplies of gas from our traditional areas and sources of supply will be adequate to meet the demand on our system in 1990[13] and, consequently, our system has been extended recently into the last few major producing areas in Texas not previously covered (Q. No. 17). To meet our future demand, we will need to rely on access to wellhead supplies of gas in other states which the FERC has recently declared are available to us.[14] However, some interests are attacking that decision, and it will likely be appealed into the courts. Therefore, we are urging Congress to revise those NGPA and NGA provisions which no longer serve a useful purpose and restrict the free flow of gas from sources of supply to the market places (Q. No. 17).[15]

Data supplied to this subcommittee by the Railroad Commission of Texas indicates that Texas natural gas reserve ratios have declined 25% during the period from 1976 to 1980[16]. Sample data submitted to TENRAC also indicates a steady erosion of the Texas intrastate markets' reserve position since 1978.[17] Additionally, the data shows that the cumulative net reserve additions for the six major intrastate pipeline companies in Texas have been less than 50% of the net reserve additions in the state - a clear indication that the intrastate pipelines are at a competitive disadvantage in competing for new gas supplies.[18]

FEDERAL AND STATE REGULATION

When passed into law in 1938, and as subsquently amended, the Natural Gas Act[19] imposed substantial restrictions in the marketing of natural gas, especially with regard to transactions between interstate and intrastate pipelines.[20] The NGPA removed most restrictions relative to the sale of gas from intrastate to interstate pipelines and in the transportation by either for the other.[21] Overlooked in drafting the NGPA, perhaps because of then existing gas supply conditions, was the sale by interstate to intrastate pipelines, which today would be beneficial for both in short-term transactions but could not be relied on by intrastate pipelines as a firm source of gas supply to meet long term commitments (Q. No. 3).[22] The rates at which intrastate pipelines provide transportation services or make sales of gas to interstate pipeline companies are established under FERC regulations and orders which are not unreasonable (Q. No. 4),[23] and intrastate pipeline rates to end users should not be mandated by the FERC or any one other than state legislatures and regulatory commissions having jurisdiction (Q. No. 4).[24]

The gas supplies of intrastate pipelines in Texas are purchased primarily at first sales from producers, and the rates of production are governed by the rules of the Texas Railroad Commission which are based on ratable takes from producers in the same field and among fields throughout the State, regardless of prices (Q. Nos. 11-12).[25]

Houston Pipe Line purchases about 4% of its gas supply from affiliated producers whose capital requirements are generated from operations and borrowings (Q. No. 20). Generally, vertical integration in the industry has been disadvantageous because of federal and state regulatory suspicion of operating practices which has generated punitive regulations[26] and has caused divestitures not necessarily in the public interest (Q. No. 20).[27]

Although Houston Pipe Line is not subject to the jurisdiction of the FERC relative to curtailments or gas sales prices generally,[28] it suggests that there will always be a need for curtailment jurisdiction and policy on the state level for intrastate pipelines and on the federal level for interstate pipelines,[29] that rolled-in pricing is preferable to incremental pricing,[30] and that pipelines must recover 100% of gas costs incurred through the operation of purchased gas adjustment procedures (Q. Nos. 15, 18-19).[31]

PIPELINE - PRODUCER CONTRACTS

Until passage of the NGPA, Houston Pipe Line negotiated and entered into contracts with producers in a free market environment without governmental regulatory directives and was required by prudence to be cognizant only of the market place and competition (Q. No. 7).[32] During this time the parties entered primarily into 20 year contracts containing price escalator clauses and take-or-pay provisions, both of which generally operated smoothly and responsively to market conditions without significant disruptions until passage of the NGPA (Q. No. 7).[33] In about 1975 Houston Pipe Line began negotiating into its contracts a provision which would allow it to reduce the price to a market clearing level, subject to a seller's option to terminate the contract, in the event the price escalated so that Houston Pipe Line considered it above market clearing levels, and, obviously, these provisions have become even more important since the NGPA introduced price controls over some categories of gas while allowing other categories to be decontrolled and to command prices far over market clearing levels (Q. No. 7).[34]

The bargaining power between Houston Pipe Line and producers and the types of pricing provisions Houston Pipe Line has accepted have been determined by the fluctuating demand for gas, changing market clearing price levels and the bids of other pipeline purchasers (Q. No. 7), but we continually attempt to be innovative and far-sighted with respect to the types of provisions we negotiate into our gas purchase contracts in order to insure that the prices we pay are not above market clearing levels. Houston Pipe Line's affiliated producers are paid not more than the price other producers in the same field are paid under contracts negotiated at arm's length (Q. No. 8).

The most common types of price escalator clauses Houston Pipe Line has in its contracts are (i) the so called "favored nations" provision which has periodic price redeterminations based on the average of the three highest prices recently paid for new gas discoveries (or in older contracts for any gas) in the area and (ii) "FPC or Area Rate" clauses which were replaced after passage of the NGPA by provisions contemplating prices tied to the NGPA's maximum lawful ceilings (Q. No. 9).[35] As long as governmental regulation establishes some wellhead prices but not others or has many pricing levels not related to market clearing prices, Houston Pipe Line will continue to have difficulty with contractual price redetermination provisions and with purchasing adequate supplies of gas at market clearing levels,[36] and renegotiation of these contractual provisions by Houston Pipe Line with producers will not occur unless Houston Pipe Line can offer equal value for the price relief sought (Q. No. 9).

Since significant renegotiation by most pipelines is unlikely and a large percentage of the contracts of other pipeline companies do not have market out provisions, this problem must be handled legislatively by Congress limiting the operation of price escalator clauses or, more preferably, by legislatively imposing in contracts the market out provision described in our recommendations below, or both (Q. No. 10).

The validity of the various types of take-or-pay provisions has not been determined judicially, and they should be dealt with legislatively by rendering them inoperative up to and during, but not after, the period of phasing into a decontrolled market (Q. Nos. 9-10).[37]

INTRASTATE EQUAL ACCESS

Those who would suggest that intrastate pipeline companies should not have equal access to gas supplies in other states or in the Outer Continental Shelf area assert that if intrastate pipelines want the benefits of interstate access, the intrastate should accept the burdens of being regulated under the NGA as are the interstate pipeline companies.[38] However, the NGPA in effect froze all pipelines' historic cost of gas, and even if intrastate pipelines became jurisdictional, they would not get the benefit of the low priced "104 cushion" gas enjoyed by most interstate pipelines. Thus, the real issue with regard to equal access by intrastate pipelines is whether there is a regulatory gap when the NGA does not become operative. There is no regulatory gap created by giving intrastate pipelines equal access to these new supplies of gas since intrastates would be subject to the same, if any, regulation interstates are subjected to at the wellhead, the rates for the interstate transportation of that gas by the interstate pipelines for the intrastate purchasers would be regulated under the NGPA,[39] and the sales rates to intrastate consumers would be covered by state law and state commissions having jurisdiction (Q. No. 21).[40]

If the national public interest is best served by eliminating federal governmental restrictions which are not helpful in assuring reasonable rates but simply impose barriers to the flow of natural gas from wellheads to the market place, then the restrictions should be removed (Q. No. 21).[41] Therefore, necessary changes to the NGPA and the NGA should be made to permit intrastate pipelines in states where reserves are dwindling to get access to gas surpluses existing in other states, as is contemplated in bills sponsored by Rep. Gramm (HR-5866) and Senator Johnston (S-2074) (Q. No. 23).

RECOMMENDED NATURAL GAS POLICY CHANGES

For the reasons expressed above, Houston Pipe Line urges consideration of changes in the federal natural gas regulatory policy as follows (Q. No. 25):

(1) All categories of gas sold at the wellhead or at a "first sale," including NGPA §104 gas, should be deregulated over a period of two to three years, with legislatively imposed contractual market out clauses which permit pipelines nondiscriminatorily to reduce all of its affected gas prices to a price it designates as its current market clearing purchasing level, and to allow the affected producers to elect to have such gas released for sale to other pipelines at higher prices, and the pipeline connected to the well or source of "first sale" should be required to transport under mutually acceptable contracts such gas at rates which are subject to the jurisdiction of state or federal regulatory agencies having jurisdiction for the account of the producers or the new purchasers.

(2) Intrastate pipeline companies should be permitted equal access to wellhead or other gas supplies in other states, from the Outer Continental Shelf, from foreign sources or from interstate pipelines in reverse NGPA §311(b) sales, which are free from NGA jurisdiction but subject to Section 311(a) of the NGPA with respect to interstate transportation.

(3) Off system sales by interstate pipeline companies to end users served by intrastate pipeline companies or brokers for end users should be at prices reflecting new gas replacement costs until all first sale gas prices are decontrolled and should be prohibited unless intrastate suppliers are not ready, willing and able to supply such gas requirements or unless the interstate pipeline companies obtain FERC authorization for long term commitments with a curtailment priority consistent with similar sales on the interstate pipeline's system.

CONCLUSION

Prior to the NGPA imposing wellhead price controls on the Texas intrastate market, Houston Pipe Line's future depended solely on its being responsive to market signals, unlike the interstate pipelines who operated under the NGA with its massive regulations which became the master to be served in lieu of the market place. With less regulatory interference to distort signals from consumers, producers and pipelines can better adapt to changing circumstances; hence, any solutions to the problems we face should involve less governmental regulation at the producer and pipeline levels of the gas industry, not more.

We believe that if gas prices are set at market clearing levels in the manner suggested above (i) consumers will not be adversely affected since the quick transition of first sale gas prices to market clearing levels will produce an aggregate price comparable to the gas prices prevalent today in every area of the country, which are at or near market clearing levels, (ii) producers will have incentive to explore for and develop the least expensive gas supplies, (iii) pipelines' contracting practices will become responsive to market clearing prices and demand, and (iv) consumers, distribution companies, producers and pipelines will be assured of receiving the benefits of the operation of a stable, predictable, orderly gas industry.

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FOOTNOTES

1/ Testimony of J. L. Terrill and James V. Walzel, On Behalf of the Coalition of Intrastate Pipelines, Before The Committe on Energy and National Resources, United States Senate, March 23, 1982. Testimony of C. M. Butler, III, Chairman FERC, Before the Committee on Energy and Natural Resources, United States Senate, March 22, 1982. Testimony of James E. Nugent, Chairman Texas Railroad Commission, Before the Subcommittee on Fossil and Synthetic Fuels, U.S. House of Representatives, August 9, 1982. Testimony of Mack Wallace, Chairman TENRAC, Before the Subcommittee on Fossil and Synthetic Fuels, U. S. House of Representatives, August 9, 1982. Petitions of Intervention filed by intrastate pipeline companies in the FERC Dockets listed at Footnote 7.

2/ Title I of the NGPA, 15 U.S.C.A. §§3311-3333, provides for a range of widely varying prices for some gas, with escalations tied to what could be a seriously understated assumption about the price of oil, but does not regulate the price for other types of gas, and establishes a schedule for only partial decontrol in 1985. Sections 311(b) and 312 of the NGPA, 15 U.S.C.A. §3371(b) and §3372, provide for the movement of surplus intrastate gas to the interstate market but not the reverse.

3/ HPL 1981 Sales - 668,882,000,000 cubic feet, 1980 sales - 648,605,000,000 cubic feet.

4/ 15 U.S.C.A. §3371(a)(2) and §3431(a)(2).

5/ 15 U.S.C.A. §3371(b)

6/ This is based on informal discussions with TENRAC representatives of studies being prepared by it.

7/ See e.g. Transcontinental Gas Pipe Line Corp. (FERC Docket No. CP82-363-000), National Fuel Gas Supply Corp. (CP82-193-000), Michigan Wisconsin Pipeline Co. (CP82-275-000), Northern Natural Gas Co. (CP82-367-000).

8/ Approximately 10% to 20% of Houston Pipe Line Company's industrial sales volumes can be easily replaced by #6 fuel oil, which is priced at about $4.25/MMBtu as of the first week of August, 1982.

9/ Sales prices of competing intrastate pipeline companies operating in the Texas Gulf Coast Area range from approximately $3.90/MMBtu to $4.30/MMBtu.

10/ Electrical generation facilities have the option of burning coal and/or fuel oil thereby making electricity an economic alternative for the domestic customer if gas prices are excessive, and LPG can be used in the place of gas by domestic customers with little cost for conversion.

11 Public Law 95-620.

12/ Several bills have been introduced in the House and Senate which would repeal or modify the Fuel Use Act, e.g. S.996, S.980, H.R.4390, H.R.4885, H.R.5866, S.2074. Also, several associations support repeal or modification of the Fuel Use Act, including the American Gas Association, the Interstate Natural Gas Association of America, the National Association of Manufacturers, the Process Gas Consumers Group. See their testimony before the U.S. Senate, Committee on Energy and Natural Resources, March 23, 1982.

13/ Depletion of reserves and increased competition since passage of the NGPA from interstate pipelines seeking to acquire new natural gas reserves have resulted in more pipelines competing for less gas.

14/ Transwestern Pipeline Company, Docket No. CP81-99-000.

15/ 15 U.S.C.A. §3371 and §3372. 15 U.S.C.A. §717 and §717f.

16/ Testimony of James E. Nugent, Chairman Texas Railroad Commission, Before the Subcommittee on Fossil and Synthetic Fuels, U. S. House of Representatives, August 9, 1982.

17/ Data supplied voluntarily to TENRAC by 6 major intrastate pipelines in Texas, Spring 1982.

18/ Interstate pipelines with a low-cost gas cushion appear to always bid the NGPA maximum lawful price for regulated gas and above-market clearing prices for deregulated gas, thereby forcing intrastate pipelines to either do the same and increase their already high cost of gas or not purchase the reserves. The NGPA functions as a Federal price support program for the benefit of interstate systems at the expense of intrastate customers, and all pipelines would likely be paying less for gas today if not for the NGPA.

19/ 15 U.S.C.A. §717(1976).

20/ 15 U.S.C.A. §717(b).

21/ 15 U.S.C.A. §3371(a) and (b).

22/ 15 U.S.C.A. §3371(b) provides for sales of natural gas from intrastate pipelines to interstate pipelines only.

23/ 18 C.F.R. §284.123 and §284.144.

24/ For example, in Texas see Vernon's Ann. Civ. St. art. 1446c §38 (1982 Supp.).

25/ Texas Railroad Commission, Statewide Rule 051.02.99.001.

26/ Texas Railroad Commission policy has been not to allow full gas cost recovery in rates between affiliated pipelines and distribution systems. Natural gas produced by interstate pipelines has been priced under area or natural rates or on a cost of service basis instead of at NGPA rates, and this issue is currently the subject of Mid-Louisiana Gas Co., et al v. FERC (5th Cir. December 1981), which has been appealed to the U.S. Supreme Court.

27/ One of the primary reasons for Houston Natural Gas Corporation selling its distribution systems to Entex in 1976 was unfavorable rate regulation imposed on city gate sales by Houston Pipe Line to these systems.

28/ 15 U.S.C.A. §717(b). 15 U.S.C.A. §§3391-3394.

29/ In the event of a short-fall in gas supplies, an orderly and rational system of gas allocation must be in place to insure that gas is made available for its most beneficial uses. Texas Railroad Commission Gas Utilities Docket No. 489.

30/ The incremental pricing provisions of the NGPA have been found to be overly complicated, often unworkable and generally not performing the task envisioned by Congress. 15 U.S.C.A. §§3341-3348.

31/ Vernon's Ann. Civ. St. art. 1446c §39. Railroad Commission of Texas v. High Plains Natural Gas Corp., 628 S.W.2d 753 (Tex. 1981).

32/ The NGPA extended wellhead price controls for the first time to the intrastate market, and no state legislation exists with respect to wellhead price controls in Texas.

33/ Section 105 of the NGPA limits the price that can be paid under an intrastate contract in existence on date of enactment. 15 U.S.C.A. §3315. The application of other sections of the NGPA to existing intrastate contracts is confused.

34/ Department of Energy, Office of Policy, Planning and Analysis, A Study of Alternatives to the Natural Gas Policy Act of 1978 (November, 1981) at page 9 (Table I).

35/ Title I of the NGPA, 15 U.S.C.A. §§3311-3319.

36/ Intrastate gas purchase contracts entered into prior to the NGPA did not contemplate federal price regulation, and much confusion and disagreement have resulted when contract provisions must be interpreted in light of the Act. Price redetermination provisions were constructed to generate market clearing prices, but this is often frustrated when producers interpret such provisions as authorizing the collection of NGPA ceiling prices which are unrelated to market conditions. FERC Orders 23 and 23A.

37/ In the FERC dockets mentioned in footnote 7, and other dockets heard by the FERC with respect to offsystem sales, the interstate pipeline companies justify the need for such offsystem sales by citing massive take-or-pay exposure.

38/ Interstate Natural Gas Association, Statement of Authur R. Seder, Jr., Chairman of the Board, Before the Committee on Energy and Natural Reserves, United States Senate, March 23, 1982, pages 6 and 7.

39/ 15 U.S.C.A. §3371(a)(1)(B).

40/ Vernon's Ann. Civ. St. art 1446c §38 (1982 supp.).

41/ The NGA and NGPA are biased against intrastate access to certain sources of gas. Testimony of J. L. Terrell and James V. Walzel, On Behalf of the Coalition of Intrastate Pipelines, Before the Committee on Energy and National Resources, United States Senate, March 23, 1982 at pages 5 - 8.

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The CHAIRMAN. Mr. Terrill.

STATEMENT OF JAMES L. TERRILL, PRESIDENT, LOUISIANA INTRASTATE GAS CORP.

Mr. TERRILL. Thank you, Mr. Chairman.

I am Jim Terrill, president of Louisiana Intrastate Gas Corp., the most extensive intrastate pipeline in Louisiana.

We do appreciate this opportunity to provide this testimony before this committee on pending legislative proposals to modify the Natural Gas Policy Act of 1978.

We are encouraged by the introduction of S. 615, and we endorse the concept embodied in this bill. We believe that this comprehensive approach is superior to any other bill currently pending before this body.

In testimony before this committee in December of last year, we stated that the NGPA must be revised before 1985. Rather than fixing temporary problems alone, which surface with changes of supply and demand, we urge you to fix what needs fixing—decontrol all wellhead prices; defuse contract terms tied to artificial above-market prices; and equalize access to all supplies of natural gas for all consumers.

We believe S. 615 provides a well-conceived, balanced plan to correct these problem areas.

The most important ingredient in any legislation to achieve a stable, natural gas market, and to put all purchasers on equal terms is total wellhead price decontrols.

Until this is achieved, the market will not be able to respond and supply and demand anomalies, such as the current situation of escalating prices in a time of surplus will continue.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Terrill follows:]

Testimony of

J. L. TERRILL

On Behalf Of

LOUISIANA INTRASTATE GAS CORPORATION

Introduction

Louisiana Intrastate Gas Corporation (LIG) appreciates the opportunity to provide testimony before this Committee on pending legislative proposals to modify the Natural Gas Policy Act of 1978 (NGPA). 1/ LIG is greatly encouraged by the introduction of the Administration's proposal by Senator McClure, S. 615, on February 28, 1983. 2/ We endorse the concepts embodied in this bill for reasons we will describe herein, and believe that this comprehensive approach is superior to any other bill currently pending before this body.

We have testified before this Committee with respect to the burdens imposed on intrastate pipelines by the NGPA. 3/ The NGPA provides for higher prices for old intrastate gas than for old interstate gas; 4/ it deregulates more intrastate gas than interstate gas; 5/ and it gives interstate pipelines an advantage in bidding for new supplies. 6/ The EIA has provided statistics which validate these conclusions which we have cited in prior testimony. 7/ The Foster Associates report on the Louisiana intrastate market, which compares acquisition costs between interstate pipelines and intrastate pipelines validates the negative price impact on intrastate pipelines. 8/ The GAO has more recently confirmed the EIA statistics and substantiated the potential of bidding disparity between interstate and intrastate pipelines in 1985. 9/

But the evidence is now even stronger. The United States Supreme Court has just recently held in the Kansas Power & Light case 10/ that NGPA treatment of the intrastates was so onerous as to justify state regulations which would mitigate some of the disparities. The Court held, inter alia, "[t]he State ... has a legitimate interest in correcting the imbalance between the interstate and intrastate markets by permitting intrastate prices to rise only to the § 109 level [instead of the § 102 price which is the incentive price allowed for newly discovered gas] .... The Kansas Act simply brings the latter category [intrastate gas subject to indefinite price escalator clauses] into line with old interstate gas prices ...." 11/ Such a significant ruling suggests that a prompt correction of the inequities in the Act is required. S. 615 treats the problems.

Impact Of S. 615 On Intrastate Pipelines

S. 615 attempts to balance competing interests both within and outside the industry, with no one group faring any better or any worse than any other. It appears to offer relief to each group for the most pressing problems, but at some cost. Intrastate pipelines are no different from any other group in this respect.

1. The Deregulation Provisions.

The most important ingredient in any legislation to achieve a stable natural gas market and to put all purchasers on equal terms is total wellhead price decontrol. The cushion of old interstate gas, so long as it stays under control, will continue to cause market ordering problems which will plague the industry. Although there has not been much talk of the cushion in recent months, the problem still remains. As recently as February 22 of this year, the GAO published the attached table in a contract study, which projects the cushion in 1985 on the major interstate pipelines. 12/ Percentages of regulated gas (§§ 104, 106, 108 and 109) after 1985 range from 40% to 80% on these pipelines. Until all wellhead prices are removed, not only the intrastates, but the 40% interstate pipeline compared to the 80% interstate pipeline, will suffer disadvantages.

S. 615 removes wellhead price controls in three phases: (1) all new and renegotiated contracts are immediately price-decontrolled unless they provide otherwise, 13/ (2) any purchaser may market-out of an existing contract beginning January 1, 1985, after which time the gas may be subject to a new or renegotiated contract and thus decontrolled, 14/ and (3) all wellhead controls are to be removed by January 1, 1986. 15/ This is a crucial part of any natural gas proposal.

2. The Price Provisions.

All first sale purchasers, including intrastate pipelines and interstate pipelines will be subject to and will determine the "gas cap." 16/ The gas cap is defined in the bill as the volume-weighted average purchase price in all first sales of natural gas pursuant to new and renegotiated contracts on a three month rolling basis. While it is very difficult to predict what price will result from this calculation, if the price is lower than the § 102 price, currently $3.34, 17/ then intrastate pipelines as well as interstates and their customers will be afforded some immediate price relief, since the bill provides that between date of enactment and January 1, 1986 the allowed maximum price shall be the lower of the current NGPA maximum lawful price or the gas cap price. 18/ However, intrastates will still be at a considerable disadvantage relative to interstate pipelines because they do not have the benefits of cheap gas to average into their overall price.

The purchased gas adjustment (PGA) cap, unlike the gas cap, applies only to interstate pipelines, since intrastate pipeline rates are not subject to federal jurisdiction. 19/ The PGA cap, however, will impact indirectly on intrastate pipelines.

The PGA cap is designed to limit interstate pipelines' automatic recovery of purchased gas costs to costs reported in the previous PGA filing plus inflation. The theory is that this will provide downward price pressure on a pipeline's bidding practices. Since two-thirds of the market will be affected, 20/ such a proposal will likely moderate the bidding of above-market prices for gas, such as have been bid in the recent past for section 107 gas.

Foster Associates reported that in Louisiana the intrastate pipelines could not afford to meet the prices bid by interstates for, not only § 107 gas, but in some cases for § 102 gas. 21/ To the extent § 107 and some § 102 reserves had been attached by intrastates, many were subsequently released because the gas was unmarketable, 22/ thereby greatly reducing reserve/production ratios and causing concern about adequate future supplies after economic recovery.

The current PGA cap proposal is designed to cause the very behavior by interstate pipelines that the intrastate pipelines were forced to engage in on their own as a result of the NGPA over the past couple of years. The difference in the two situations is simply one of bidding flexibility. Because of the availability of the cushion, the interstates had great bidding flexibility, since they could roll-in all costs. Since the intrastates had no cushion, their costs were already approaching a market price for gas; thus, there was no margin allowing bidding comparable to that type engaged in for section 107 gas by some of the interstates.

Some have suggested that the PGA cap limitation on the interstate pipelines will reverse the bidding disparity and put some interstates at a disadvantage once again, vis a vis intrastate pipelines. This fear is unfounded since it assumes the intrastates can retain their markets at higher prices. As the past year and a half has shown, such is not the case. In fact, what the experience over that period has demonstrated is that the intrastate pipelines have to deal with some of the most price sensitive markets in the country. Because of our high industrial loads, 23/ the competitive pressures of alternative fuels affect a disproportionately large segment of our customer load as compared to the interstates. Thus, we feel it is unlikely that the PGA cap will result in a dual market.

3. Access Provisions.

Intrastate pipelines have argued for access to new supplies under the same terms as are available to interstate pipelines. 24/ This includes access to offshore reserves, production in other states, repeal of abandonment and the right of first refusal, ability to purchase gas under abbreviated § 311 procedures, and insulation from Natural Gas Act (NGA) jurisdiction for these and related activities.

Several points are in order. Intrastate pipelines are not asking for more favorable treatment than that afforded interstate pipelines. To the extent offshore gas is transported onshore, such transportation crosses state lines, and is therefore in interstate commerce and subject to FERC jurisdiction. 25/ If an intrastate wants to do the transporting, then it must follow the same procedures as an interstate pipeline. As we understand the access amendments in S. 615, 26/ they would simply ensure the right of an intrastate pipeline to purchase offshore gas.

The same rationale applies to state-to-state transactions. The FERC has recently held that an intrastate pipeline may purchase gas from a producer in another state without the sale becoming jurisdictional. 27/ In addition, the Commission allowed an intrastate pipeline to sell to an industrial user in another state without the sale becoming subject to federal jurisdiction. 28/ The amendments in S. 615 would reaffirm FERC's authority to implement such policy.

Repeal of the NGA abandonment provisions 29/ and NGPA right of first refusal 30/ would mean that once a contract expires both interstate and intrastate purchasers could bargain for the gas on equal terms. Under existing law, anyone may purchase gas under an expired intrastate contract, whereas gas under an expired interstate contract is effectively dedicated forever to interstate commerce.

The amendments to §§ 311 and 312 of the NGPA 31/ broaden the scope of existing law. They allow § 311(a) transportation on behalf of end users, and they provide for § 311(b) sales and § 312 assignments to be made from interstates to intrastates.

In general, these amendments would facilitate non-jurisdictional transactions for not only intrastate pipelines, but also industrial users, and here is the rub. In loosening access transactions, our customers are now better able to compete against us for supplies, and pipelines in other states are better able to compete against us for our traditional customers. Thus, the policy cuts both ways. We are not suggesting that end users should be barred, only that there are potential costs as well as benefits for intrastate pipelines under these provisions.

Related to increased access to supplies is the contract carriage provision in S. 615, 32/ which provides that FERC can order an interstate pipeline to transport gas if there is capacity, no new facilities are required, and service is not impaired to existing customers. Besides the PGA cap, this is the other major provision of the bill which does not apply directly to intrastate pipelines. The mandatory transportation under the take-or-pay and market-out provisions 33/ gives state agencies with jurisdiction over intrastate pipelines authority analogous to that provided the FERC.

We do not know whether this difference between the mandatory transportation and contract carriage provisions was intended by the drafters of the legislation. It may be, however, that including intrastates under the contract carriage would create an impossible burden at the FERC. It would result in hundreds of transmission and local distribution companies located throughout the country filing with the FERC for the first time. To the extent there is a problem, the jurisdictional state body is the appropriate body for making such a determination. We are not aware of any intrastate pipeline in Louisiana refusing to transport for a direct purchaser when there is capacity. In fact, such transportation is commonplace and encouraged as an additional method of earning revenues. In addition, some states including Louisiana already have statutes authorizing State Commissions to mandate transportation under certain circumstances. 34/ Thus, the perceived difference in treatment under the contract carriage provision is benign.

Other Legislative Proposals

During the Lame Duck hearings we commented on the bills by Senators Kassebaum, Jepsen, Eagleton and Danforth, which have been reintroduced in this Congress. 35/ Rather than repeat those comments, we incorporate them herein by reference. Suffice it to say, we believe that neither a price freeze nor isolated contract fix proposals solve the major problems facing the natural gas market.

Comment has been requested on two additional bills: S. 370, introduced by Senator Percy, 36/ which limits the price of imported liquefied natural gas (LNG) to the price of #6 oil, and the bill introduced by Senator Heinz, S. 689, 37/ on March 3, 1983.

With respect to the issue of imports we support whatever measures are necessary to encourage domestic production and thus would support Senator Percy's bill.

S. 689, however, is another variety of legislation that misses the mark by failing to totally deregulate at the wellhead. In addition, we take issue with the express discriminatory treatment of intrastate pipelines. One of the purposes listed in Title I is to "[a]ssure gas supply security to interstate markets." In addition, the market-out right specifically does not apply to certain intrastate pipeline contracts, since according to Senator Heinz, "a record which establishes the necessity for a market-out in such contracts does not presently exist." 38/ We respectfully point out that according to the EIA contract study, market-out clauses were found in only 14% of pre-NGPA intrastate contracts and 27% of post-NGPA intrastate contracts. 39/

If the federal government is going to provide relief from burdensome contractual provisions, such relief should apply to all consumers of natural gas and to all categories of gas.

Conclusion

We endorse comprehensive natural gas legislation along the lines of S. 615. The essential feature of that, or any, legislation is decontrol of old interstate gas. Until all gas is decontrolled, the market will not be able to respond, and supply/demand anomalies, such as the current situation of escalating prices in a time of surplus, will continue.

ENDNOTES

1/ 15 U.S.C. §§ 3301-3432 (Supp. 1982).

2/ S. 615, 98th Cong., 1st Sess. (February 28, 1983).

3/ See Testimony of J. L. Terrill and Stan L. McLelland on Behalf of The Coalition of Intrastate Pipelines, December 13, 1982; and Testimony of J. L. Terrill and James V. Walzel, On Behalf of The Coalition of Intrastate Pipelines, March 23, 1982.

4/ The maximum lawful price for §§ 104 and 106(a), old and rollover interstate gas, ranges from $ .28 to $2.27/MMBtu for March 1983. The maximum lawful price for § 105, old intrastate gas, is $3.34 for March 1983. 48 Fed. Reg. 3719-20 (January 27, 1983).

5/ Department of Energy, Energy Information Administration, An Analysis of the Natural Gas Policy Act and Several Alternatives, Part I, The Current Status of the Natural Gas Market 48 (December 1981).

6/ E.g., all gas dedicated to interstate commerce prior to November 8, 1978 and not exempted from Natural Gas Act (NGA) (15 U.S.C. § 717 (1976)) provisions by the NGPA, as high cost Section 107(c)(1) - (4) or new Section 102(c) or Section 103 gas, is still subject to NGA jurisdiction. This means that such gas must forever remain dedicated to a particular interstate pipeline unless the Commission authorizes abandonment pursuant to § 7(b) of the NGA (15 U.S.C. § 717f(b)). See also § 315(b) of the NGPA which provides that current purchasers of certain categories of interstate gas have a right of first refusal (15 U.S.C. § 3375(b)).

7/ See note 3, supra.

8/ In March 1982, the volume weighted average gas acquisition cost for interstate pipelines operating in Louisiana was $2.67, compared to $3.45 for the major intrastate pipelines (other than the Texaco affiliate). Foster Associates, Inc., The Impact of the NGPA on Intrastate Markets in Louisiana 28 (June 1982) [hereinafter cited as Foster Report].

9/ By the Comptroller General, Report to the Subcommittee on Environment, Energy and Natural Resources, House Committee on Government Operations, An Analysis of Natural Gas Pricing Policy Alternatives, Vol. 1, 22-24 (February 3, 1983).

10/ Energy Reserves Group, Inc. v. Kansas Power and Light Co., No. 81-1370 (U.S. January 24, 1983).

11/ *Id*., slip op. at 15-16.

12/ Report by the Comptroller General, Information on Contracts Between Natural Gas Producers and Pipeline Companies 49 (February 22, 1983).

13/ S. 615, § 201.

14/ *Id*. at § 303.

15/ *Id*. at § 201.

16/ *Id*. at § 301.

17/ 48 Fed. Reg. 3719-20 (January 27, 1983).

18/ S. 615, § 301.

19/ S. 615, § 101.

20/ Department of Energy, Energy Information Administration, Monthly Energy Review 50 (January 1982).

21/ Foster Report, *supra* note 8, at 39.

22/ *Id*. at 42.

23/ *Id*. at 5.

24/ *See* testimony, *supra* note 3.

25/ § 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b).

26/ S. 615, Title IV.

27/ Transwestern Pipeline Co., Docket No. CP81-99 (May 25, 1982).

28/ United Gas Pipe Line Co., Docket No. CP81-52 (May 25, 1982).

29/ 15 U.S.C. § 717f(b) (1976).

30/ 15 U.S.C. § 3375(b) (Supp. 1982).

31/ 15 U.S.C. § 3371 (Supp. 1982).

32/ S. 615, § 403.

33/ S. 615, §§ 302 and 304.

34/ E.g., in Louisiana, the Commissioner has authority to investigate the need for using excess capacity on a pipeline and, if not provided by contract, may require an intrastate pipeline to transport intrastate supplies. See Natural Resources and Energy Act of 1973 (Act 16), La. Rev. Stat. 30: 546 (1973).

35/ The bills as reintroduced in this Congress are as follows: S. 60, introduced by Senator Kassebaum, January 26, 1983; S. 239, introduced by Senator Jepsen, January 27, 1983; S. 293, introduced by Senator Eagleton, January 31, 1983; S. 291 and S. 292, introduced by Senator Danforth, January 31, 1983. See Testimony of J. L. Terrill and Stan L. McLelland of December 13, 1982, supra note 3.

36/ S. 370, 98th Cong., 1st Sess. (February 1, 1983).

37/ S. 689, 98th Cong., 1st Sess. (March 3, 1983).

38/ 129 Cong. Rec. S2139 (daily ed. March 3, 1983).

39/ Department of Energy, Energy Information Administration, Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market, An Analysis of the Natural Gas Policy Act and Several Alternatives, Part II, at ix (June 1982).

Table 7

Post-1985 Regulated Gas (NGPA sections 104, 106, 108, and 109) as a Percentage of Total Gas Purchases of Major Interstate Pipelines (note a)

Pipeline	Post-1985 regulated gas (percent)	Average acquisition price (note b) (per MMBtu)
Texas Eastern Transmission Corp.	80	$1.30
Kansas-Nebraska Natural Gas Co.	78	$1.62
Natural Gas Pipeline Co.	75	$1.80
Tennessee Gas Pipeline Co.	72	$2.04
Texas Gas Transmission Corp.	70	$2.17
Northern Natural Gas Co. (note c)	70	$1.56
Florida Gas Transmission Co.	68	$1.88
Trunkline Gas Company	68	$2.53
Panhandle Eastern Pipeline Co.	66	$1.63
Michigan-Wisconsin Pipeline Co.	66	$2.21
Northwest Pipeline Co.	63	$1.81
El Paso Natural Gas Co.	60	$2.28
Consolidated Gas Supply Corp.	58	$2.00
Southern Natural Gas Co.	57	$2.67
Transwestern Pipeline Co.	54	$1.96
Cities Service Gas Co.	51	$1.98
Colorado Interstate Gas Co.	50	$2.65
United Gas Pipeline Co.	46	$2.58
Transcontinental Gas Pipeline Co.	44	$2.76
Columbia Gas Transmission Corp.	40	$2.74

a/The data in this table were obtained from a study prepared by FERC in January 1982, with EIA assistance, at our request. The data are based on pipeline companies' PGA filings with FERC in late 1981. (See footnote on p. 48.) It should be noted that section 102(d) gas and some section 103 gas will also remain regulated after January 1, 1985, but data for these two categories were not available for inclusion in this table. In addition, because this table reflects only pipeline purchases of gas from producers, the percentages of post-1985 regulated gas for individual pipelines will vary due to a number of factors not reflected in this table. For example, a pipeline may purchase substantial quantities of gas from other pipelines, such as Consolidated. A pipeline may produce its own gas at low regulated rates, such as El Paso, or have significant volumes of section 102(d) gas, such as Columbia.

b/Includes taxes, gathering, and other charges for all gas.

c/Late 1980 data.

Source: Report by the Comptroller General, Information on Contracts Between Natural Gas Producers and Pipeline Companies (February 22, 1983).

The CHAIRMAN. Mr. Greehey.

STATEMENT OF WILLIAM GREEHEY, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, VALERO TRANSMISSION CO.

Mr. GREEHEY. Mr. Chairman. Members of the committee.

I also appreciate the opportunity to be here today.

I am Bill Greehey, chief executive officer of Valero Transmission Co. We operate an intrastate pipeline that operates wholly within the State of Texas.

On balance, we think the Senate bill 615 is a comprehensive and well-reasoned approach to the problems of the Natural Gas Policy Act. We are not here today looking for legislation that will favor the intrastates, to give us a competitive advantage; but we are seeking equitable solutions to the problems of the NGPA.

The intrastate pipeline problems are not well known in Washington. We believe that this committee will weigh our concerns, our problems in considering this legislation. Since 35 percent of the national industrial market is served by the intrastate pipelines, it is not only a regional impact, but also has broader, national impact on our economy.

Since passage of the Natural Gas Policy Act, prices have been distorted and they have not responded to supply and demand.

Again, the reason is that intrastate 104 gas which allows the intrastates to pay a higher price, since they have the old regulated gas to keep the prices down.

The competitive effect of this has been the same as if the Government was subsidizing the price on the new gas that the intrastates were paying for.

The intrastates have had to match these prices if they expected to replace the reserve. In the case of the premium price gas, which is the tight gas, deep gas, we have not been able to compete, and these are areas that we had previously relied upon for our gas and supply.

We think that the administrative proposal goes a long way toward eliminating these problems.

We do have several concerns with the bill, which we feel should be addressed. The pricing in market out deals only with first sales. Most pipelines purchase gas from gas gatherers. The gatherers buy the gas from producers. The gatherers sell it to a pipeline.

Most pipelines buy the gas this way. In some cases, there may not be an incentive for the gatherer to exercise their market out or reduce the prices, since they may lose the gas supply and would go to another gatherer.

The second concern that we have is the ability of the producers to make direct sales to industrial customers. Industrial customers have a constant load and the pipelines previously have relied upon these sales to serve the residential and commercial customers whose load fluctuates with seasonal demand.

Pipelines may not be able to buy sufficient gas to meet these peak requirements, if they lose all of their industrial market.

Since the industrial sales made by producers would not be subject to a curtailment plan at the State level or a Federal level, you could have a situation where you have curtailment to residential, commercial customers, and yet the industrial customers would continue to burn gas.

We think that these modifications will strengthen the bill. We commend the administration on this bill, and also the committee for their prompt action in this hearing.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Greehey follows:]

TESTIMONY of William Greehey,
Chairman of the Board and Chief
Executive Officer,
Valero Transmission Company
Before Senate Committee on
Energy & Natural Resources
Thursday, March 10, 1983

MR. CHAIRMAN, I appreciate the opportunity to appear before this Committee as a representative of an intrastate natural gas pipeline. I am Chairman of the Board and Chief Executive Officer of Valero Transmission Company, an intrastate natural gas pipeline operating solely within the State of Texas. Valero is one of the largest intrastate pipeline companies operating in the United States. We serve directly or indirectly virtually all of the State of Texas excluding the Texas Panhandle area.

I. INTRODUCTION

Before commenting on the specific provisions of any particular piece of legislation, I would like to state at the outset, Mr. Chairman, that we as a company are not interested in using any legislative vehicle to provide us with a competitive advantage whether short-term or long-term. We are well aware that our economic growth for the future is tied into the intricate network of natural gas markets and supplies. We therefore seek a comprehensive, stable, equitable solution to the problems of disorder that now exist in the natural gas industry. In that regard I think we share the long-term and short-term objectives of this Committee and of Congress.

We are concerned that the problems of the intrastate natural gas industry are not as well known in Washington as the other segments of the industry. Since we existed prior to 1978 in a free market confined to our own states without being intertwined in the federal regulatory apparatus, we have neither national associations nor large-scale representation at the federal level. Therefore, we sometimes feel we are not adequately taken into account as federal policy is determined. This is despite the fact that approximately thirty-five percent of the nation's industrial requirements for natural gas are being met by the intrastate transmission companies like Valero. Intrastate gas is extremely important to the country's agricultural base, to the petrochemical industry, to electric generation, and other industrial segments. Therefore, we think it is critical, as this Committee weighs the solutions to problems in the natural gas industry, that it take into account their impact on the intrastate natural gas industry. The intrastate market does not have a simple regional impact but has a broad effect on the overall economy of this nation and the overall natural gas industry.

II. CRITERIA FOR LEGISLATION

In judging any legislative solution to the problems in the natural gas industry, we have the following criteria:

1. No company should be given a pricing advantage in purchasing natural gas supplies because of the operation of federal law or regulation. Competition for supplies of gas should be on a fair and equal basis for all pipelines and no company should have an advantage because of the operation of federal law or regulation.

2. All pipelines should have an opportunity to bid for all gas irrespective of geography or location. Access to all supplies should be on a fair and equal basis.

3. No company should receive any competitive advantage in regard to marketing their gas by virtue of federal law.

While these standards may seem oversimplified, they help explain the perspective intrastate natural gas pipeline companies have when judging the impact of various legislative proposals.

III. 104 GAS CUSHION

Until the adoption of the NGPA in 1978 the prices paid by intrastate pipelines for gas in the field were not regulated by the Federal Government. We existed in a classic free market system. As a result, at the time of the passage of the NGPA most of the gas on intrastate pipelines systems was generally priced at a market-clearing level. Not only were the new contracts negotiated at market-clearing prices but the old contracts generally provided for periodic escalations to levels equal to the average of the three highest prices being paid in a producing area. Therefore, for the most part, old gas and new gas were priced identically at a market-clearing level. This is in stark contrast to the interstate market where prices for old gas were held to a price below the market-clearing level which created a low priced cushion of gas for the interstates. This cushion in turn, because of the industry practice of rolled in or average prices, gave the interstates a pricing advantage in competing for new gas supplies. They could pay a higher price for new gas since the old regulated gas kept their average cost of gas down. The competitive effect was the same as if the Federal Government had subsidized part of the price of new gas purchasers.

We in the intrastate market believe this cushion has created most of the problems that presently face the natural gas industry. It is this low-priced gas that has allowed unrealistically high prices to be bid for new supplies. In order to get new supplies we have had to match these high prices or be unable to add to our natural gas reserves. In addition, these high prices for new gas have been the standards to which, by operation of contract, the prices for many other categories of gas have escalated.

There should be no misunderstanding that an intrastate's lack of old 104 cushion gas is not related to good or bad management decisions but is simply the result of a historical action taken by the Federal Government. This accident continues to plague us in the intrastate pipeline market and has several ramifications.

First of all the interstates have been able to pay higher prices for gas than a free market would otherwise dictate. This meant that in order to replace our reserves we were forced to match these high prices, primarily for deep and tight sands gas. As a result, we to some degree have been rendered economically noncompetitive for a substantial portion of the supplies that are currently becoming available in the supply area upon which we have traditionally relied and to some extent to which we are restricted.

It is indeed ironic that intrastate pipelines which furnish energy to the very states where most of the energy is produced can no longer afford to purchase certain new gas supplies developed within their own states' borders. These intrastate pipelines, who lived successfully in a free market for many years and who, by paying market prices, kept drilling activity in this country alive before NGPA have now become the victims of NGPA.

The Administration's proposal, introduced as S. 615, goes a long way toward alleviating this advantage. By deregulating 104 gas on January 1, 1986, and by allowing producers an opportunity to market out of old gas contracts that are not renegotiated, this essentially removes old 104 gas from the position that allows it to subsidize purchases of higher priced gas, a competitive advantage of deep cushioned pipelines. Other legislation, insofar as it does not address the 104 price cushion, falls short of bringing a solution to bear on disorder in the natural gas industry. We feel strongly that legislation such as the so-called Natural Gas Consumers Relief Act is very illusory in providing the relief for consumers that the authors seek. It is ironical that the objective of legislation such as this preserves the existence of the same gas category that has caused so many of the market distortions that ends up hurting consumers.

We share the objective of legislators who seek to protect consumers from excessive natural gas prices. But, so long as consumers pay prices based on an average cost of gas, holding one type of gas at an unrealistically low price, simply encourages unrealistic higher prices to be paid for other categories of gas.

We believe, for any legislation to be successful in bringing price order to the industry, old section 104 gas must be prevented from subsidizing other gas purchases. It must be either allowed to rise to the market-clearing level, isolated from average pricing, or dedicated to separate purposes -- somehow it has to be removed from the process of bidding for new supplies.

In addition to the problems of competing for new gas supplies at reasonable prices which have been created by the old 104 gas cushion, the 104 cushion has also skewed and dislocated the marketing side of the equation. In this time of surplus supplies there have been some deep cushioned pipelines who have attempted to sell their gas in off-systems sales to our traditional customers as well as those customers of interstate pipelines having little 104 cushions. While we feel fair competition is essential, we do not believe the existence of the interstate 104 cushion should allow these pipelines to dump their surplus gas to the traditional industrial and distribution customers of intrastate pipelines. The only reason these interstates are able to undercut our prices and attempt to take over our markets is the unfair advantage they have been given by the NGPA of having the price of this cushion of old gas held down at artificially low price levels. If this market raiding is allowed to exist, these pipelines can keep their takes from purchasers high and thus remain attractive purchasers for new gas discoveries while we, who have our markets displaced, become unreliable purchasers. Therefore, the unfair competition in our markets in turn has an impact on our ability to obtain new supplies. We feel strongly that we must either move toward a free market system or our markets must be insulated against using legislative price advantages to cause major market dislocations.

We are convinced that the treatment of 104 gas afforded by S. 615 is a fair and equitable way to provide maximum price protection to the ultimate consumer while at the same time restoring order to the natural gas business and making that business responsive to free market forces. We feel that if this bill is enacted those market forces will best serve the public interest by providing adequate supplies of natural gas at the lowest possible price and this is the best protection that the consumers can ever want.

IV. COMPETITION FOR NEW SUPPLIES: ACCESS

By virtually all accounts it is simply a matter of time before the historical supply areas of the intrastate pipelines reach full maturity. Indeed reserves in areas such as Texas and Louisiana have been rapidly declining over the past several years. Therefore, in order to adequately serve our customers it is necessary for us to compete for new supplies wherever they may be located. Moreover, if fair competition is a desirable component in restoring the natural gas industry to equilibrium, there is no reason why intrastates should be arbitrarily prohibited from competing for supplies outside their State borders. Therefore, anticipating that we in Texas will in the future be net importers of natural gas to satisfy the needs of our customers, we believe it essential that any legislation address this issue and provide equal access to new supplies of gas.

At the present time the gas underlying federal waters along the Outer Continental Shelf is currently reserved only for interstate pipelines. In 1980, 5.5 Tcf of gas was produced from the OCS, and none of this amount was available to customers served by intrastate pipelines. We applaud the Administration's bill insofar as it provides access to the OCS gas and removes the prohibition against pipelines, which serve customers located in producing states, purchasing gas supplies for their customers wherever those supplies happen to be located. We would urge that as our nation moves to a freer gas market there should be no discriminatory restrictions on intrastates purchasing gas supplies wherever they may be found, whether in the OCS, the Rocky Mountains, or imports from Canada or Mexico.

V. SUGGESTED MODIFICATIONS

While we believe that S. 615 is certainly preferable to the current situation under the NGPA and is also better than other proposals which have attempted to address only symptoms of the problems of the natural gas industry in a piecemeal fashion, we think there are certain areas where the bill could be strengthened.

First, in the area of pricing and market-outs, the bill deals only with first sales. In addition to direct producer purchasers most pipelines, including Valero, purchase gas from gatherers and those who provide gathering services regardless of definition. In many cases these entities which provide gathering services may not have an incentive to exercise market-out provisions or negotiate the most favorable price with producers, especially if it could mean losing the gas to some other gatherer or pipeline. This is because the gatherer only gets paid according to the volume of gas it transports and loss of supply, regardless of price, leads to a reduction of revenues by the one providing the gathering services.

Therefore, the market-out provisions of the act should equally apply to those contracts which these pipelines have with gas gatherers and those entities, regardless of definition, which purchase gas directly from producers and resell that gas solely to other pipelines. Unless the bill is expanded to include these contracts, pipelines will have no way to effectively control their gas costs.

A second area of concern is the ability of producers to make direct sales to industrial customers and force pipelines to transport their gas. The constant load created by industrial sales has permitted pipelines to provide adequate service to their residential, commercial and electric generation customers whose demand experiences tremendous seasonal swings. If the relatively constant industrial demand is shifted to contracts directly with producers, pipelines may not be able to acquire sufficient gas deliverability to meet these peak requirements of their customers whose demand fluctuate severely with change in temperature. Producers will always prefer to contract directly with industrial customers who can assure constant high takes rather than pipelines which have to cut back on takes during the spring and fall in order to have sufficient gas available to meet the peak demands of their residential and commercial customers in the winter and electric generation customers in the summer. In addition to the problem of competing with industrials for gas supplies, this so called equal access by consumers will also remove gas sold directly by producers to industrial users from the curtailment authority of the FERC and state regulatory commissions. Thus, during periods of gas shortages, low priority industrial consumers would continue to burn gas under boilers at the same time pipelines were having to interrupt deliveries to homes, schools and hospitals. Consequently, we believe that the "equal access" provisions of the bill should apply only to pipelines and local distribution customers in order to insure maximum protection of the public interest.

Finally, we are somewhat concerned with the effect of Section 302 of the bill which purports to limit take-or-pay provisions. We believe that language should be clarified to insure that, by exercising the 70% take-or-pay option, a pipeline does not lose the right to call upon, when needed, 100% of the well's deliverability and that a producer, by electing to terminate a portion of the contract, does not gain the right to market separately 30% of the well's deliverability on an uninterruptible basis. This clarification is needed to insure that a pipeline will have sufficient deliverability to meet its peak swing demand.

VI. CONCLUSION

Mr. Chairman, we believe that on balance this S. 615 provides a comprehensive and well reasoned approach to the problems that have been created by the NGPA. We feel that those modifications outlined in this testimony, if incorporated, will strengthen the bill and provide adequate safeguards for the public interest. We commend the Administration for its efforts to restore order and sanity to the natural gas industry and applaud this Committee for its actions in expediting consideration of this measure.

The CHAIRMAN. Mr. Jones.

STATEMENT OF VERNON T. JONES, EXECUTIVE VICE PRESIDENT, THE WILLIAMS CO.

Mr. JONES. Mr. Chairman and members of the committee, my name is Vernon T. Jones, and I am executive vice president of the Williams Co. It is a Tulsa, Okla., corporation engaged in the fertilizer, energy, and metals business.

Williams is a company which is simultaneously a major consumer, transporter, pipeline seller, and producer of natural gas.

As we have outlined in my written statement, Williams' experience has demonstrated that the natural gas industry has become increasingly disordered under the regulatory scheme established by the Natural Gas Policy Act.

From this experience, we believe that changes must occur to the scheme as soon as possible, if rational economic decisions are to be made in the future by our company, and others affected by the price and availability of natural gas.

As a major consumer dependent on natural gas, we find S. 615 to strike a proper balance between restoring a rational economic order to the pricing of gas to the consumer on one hand, and insuring sufficient incentives remain to the producer on the other, to insure an adequate supply of gas to meet the Nation's future needs.

We also find that S. 615 largely is fair in its treatment of interstate and intrastate pipelines and consumers alike. And that it provides to both classes of pipelines and consumers adequate tools to permit them to restore order to their respective shares of the gas industry within a reasonable period.

While our company is a consumer, transporter, pipeline seller, and producer of natural gas, our interests are largely those of a consumer. As the largest noncooperative hydrogenous fertilizer manufacturer in the United States, our subsidiary, Agrico Chemical Co., uses approximately 7 billion cubic feet of gas each year, or an amount approximately equal to the total gas consumed annually in the State of Connecticut.

Since 1978, the price of gas has increased by 122 percent to our Arkansas facility, 65 percent to our Louisiana facilities, and by 94 percent to our Oklahoma facilities. Similar dramatic increases have also been incurred by others in the industry.

And as a result, they have severely reduced the competitive viability of the domestic fertilizer industry. These increases have also played a significant role in causing the increased prices which the American farmers have been called upon to bear for his fertilizer inputs during this same period.

From this perspective, I am disturbed that some may attack this bill as a proproducer anticonsumer measure. We support S. 615 because it will lower the price of natural gas consumed in our fertilizer plants and purchased by our pipelines.

We support this bill, because it will lead to a single natural gas market without the market distortions that have been experienced in the wake of the *Phillips'* decision or the NGPA.

We support the bill, even though after enactment, it will lower the average price paid for natural gas produced by our exploration subsidiary. Because it will provide for an orderly gas market, with still-sufficient incentives for us to make long-term investments in natural gas exploration and development.

We welcome these hearings and the abundance of legislative proposals being considered as demonstrating agreement with us that the present regulatory scheme is not working. We believe that the best solution is that proposed by S. 615 with its phased elimination of all price controls while maintaining consumer protection.

I appreciate the opportunity to appear before you today and will be pleased to respond to any questions.

The CHAIRMAN. Thank you, very much.

[The prepared statement of Mr. Jones follows:]

STATEMENT OF VERNON T. JONES
EXECUTIVE VICE PRESIDENT, THE WILLIAMS COMPANIES

March 10, 1983

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

Good morning. My name is Vernon T. Jones. I am Executive Vice President of The Williams Companies (Williams), a Tulsa, Oklahoma-based corporation engaged in the fertilizer, energy and metals businesses. I am appearing before you today as a representative of a company which simultaneously is a major consumer, transporter, pipeline seller and producer of natural gas. As such, we obviously have a strong interest in the subject matter of these hearings and appreciate the opportunity to appear before you on this topic today.

Williams has long been concerned that the natural gas industry increasingly is becoming disordered under the current regulatory scheme and that changes must occur to that scheme if rational economic decisions are to be made in the future by Williams and others affected by the price and availability of natural gas. On balance, we are of the opinion that S.615 currently provides the best overall framework for making that change.

As a major consumer dependent on gas, we find S.615 to strike the proper balance between restoring a rational economic order to the pricing of gas to the consumer on the one hand and ensuring that sufficient incentives remain to the producer to assure an adequate supply of gas to meet this nation's future needs on the other. We also find S.615 largely to be fair in its treatment of interstate and intrastate pipelines and consumers alike, and to provide both classes of pipelines and consumers with adequate tools to permit them to restore order to their respective shares of the gas industry within a reasonable period.

My remarks are divided into four parts. I will begin by briefly explaining the role which Williams currently plays in the industry, and then, in turn, will address our perception of the nature of the problems which currently are confronting the industry, the solutions which we view as appropriate to meet these problems, and, finally, in those instances where we urge that the Committee consider refinements to S.651, the nature and rationale for such refinements.

I. WILLIAMS' ROLE IN THE GAS INDUSTRY

A. Consumer

Through its subsidiary, Agrico Chemical Company (Agrico), Williams is a major consumer of natural gas. Agrico, the largest independent nitrogenous fertilizer producer in the United States, uses natural gas largely as a feedstock in the production of ammonia, a product basic to the production of wheat, corn, rise and forage crops by farmers throughout the United States.

Currently, there is no practicable alternative to the use of natural gas in the ammonia production process. Thus, the continued availability of natural gas to companies like Agrico is essential if they are to continue to meet the fertilizer needs of the American farmer. Certainly, as important as is the availability of gas to the fertilizer producer is the price at which such natural gas is acquired. At current price levels, natural gas-related costs often constitute in excess of 85 percent of the total cost incurred by an ammonia producer in producing this product. At such a high level, it is apparent that natural gas costs are the primary determinant of whether a given ammonia producer is able to remain competitively viable, and, in large part, are a significant determinant of the price level which the American farmer must bear for his fertilizer inputs.

Agrico's facilities are located on both interstate and intrastate systems. Except for electric generation facilities, Agrico's facilities are the single largest consumer of gas on each of the systems from which Agrico is served and are the single largest gas consuming facilities in both Arkansas and Oklahoma. Combined, Agrico uses

70 billion cubic feet of gas per year, or roughly an amount equal to the total of gas consumed annually in the State of Connecticut.

B. Pipeline

Through its subsidiaries, Faustina Pipe Line Company, Louisiana Resources Company, and Williams Gas Supply Company (together referred to as the Williams Natural Gas group), Williams is a major intrastate transporter and pipeline seller of natural gas. Combined, these companies form the second largest independent (non-integrated) pipeline system in the State of Louisiana with sales equal to approximately one-eighth of the State's daily intrastate requirement.

The customer profile (both direct and indirect) of Williams Natural predominantly is composed of large-volume industrial consumers. While Williams Natural's customers use natural gas both for feedstock/process uses and as boiler fuel, most such consumers in one way or another are inextricably linked to the chemical industry. It is Williams Natural's experience that, because gas costs are one of the largest segments of operating costs for such industries, the competitive viability of its customers, especially those which use gas as a feedstock or process fuel, are substantially affected by the price and availability of gas.

C. Producer

Through its subsidiary, Williams Exploration Company (Williams Exploration), Williams is a significant producer of natural gas. Although predominantly centered in south Louisiana, Williams Exploration has substantial interests also in the Overthrust Belt, in Texas, and in the Williston Basin.

Because it is a relatively new entrant in the gas industry, Williams Exploration may be classified predominantly as a "new" gas producer. Williams Exploration produces relatively insignficant amounts of NGPA §104 gas, and has concentrated its efforts most recently on the development and production of NGPA §102 reserves, although it also has substantial interests in NGPA §107 gas. Williams Exploration is actively engaged currently in the exploration for and production of additional new gas reserves, and sells gas currently into both the interstate and intrastate markets.

II. WILLIAMS' PERCEPTION OF THE PROBLEMS (AND THE CAUSES THEREOF) WHICH CURRENTLY CONFRONT THE GAS INDUSTRY

A. The Extent of the Problems Which Currently Exist

During the last few years, Williams has been buffeted by increasing disorders in the natural gas industry. From its perspective as a consumer, Williams has watched as the delivered price of gas has increased incessantly until it currently is threatening to render Williams' fertilizer operations non-competitive. As a pipeline seller, despite continual and innovative efforts to obtain sufficient supplies of gas to meet the needs of its customers at economically practicable price levels, Williams nevertheless has continued to experience a substantial degree of load loss. Finally, as a producer, Williams has been exposed to increasingly confused signals from the market concerning the extent to which sufficient incentives exist to encourage Williams to continue explore for and develop new supplies of gas.

These disorders are causing severe injury to Williams and others in the gas industry. Agrico's experience on this point is particularly instructive. During the last few years, Agrico has watched as the price of its natural gas feedstocks has continued to rise dramatically. Since 1978, the price of gas has increased by 122 percent to Agrico's Arkansas facilities, by 65 percent to Agrico's Louisiana facilities, and by 94 percent to Agrico's Oklahoma facilities. During the same period of time, Agrico has experienced continual declines in the demand for and price of its fertilizer production. While continued depression in the farm economy has severely dampened domestic demand for fertilizer, increased imports of foreign-produced fertilizer (produced from more cheaply valued foreign gas reserves) have served significantly further to impair the already reduced market position of Agrico and other domestic fertilizer producers.

Such forces have combined already to render many domestic fertilizer producers non-competitive. It has recently been estimated in proceedings before the Oklahoma Corporation Commission that only 65 percent of the domestic nitrogenous fertilizer industry is operating and that even lower levels must be expected if domestic gas costs continue their incessant increase. Although it is a matter which need not be fully developed in these proceedings, I would note that such a continued deterioration in the viability of the domestic fertilizer industry carries with it severe national security implications because the foreign suppliers which are displacing these domestic producers are in many instances located in countries with foreign policy goals far different from those of the United States.

The reduction in the demand for gas by Agrico and other fertilizer producers has affected not only such producers' economic condition but also that of other gas consumers. For example, in Oklahoma, 30 percent of the load served by the state's largest gas utility historically is fertilizer related and 35 percent of that utility's net operating income is derived from such sales. Recent testimony before the Oklahoma Corporation Commission indicates that the recent reduction in the level of such sales (due to reduced fertilizer production) is in large part responsible for the recent $88.4 million rate increase requested by the utility. Further evidence indicates that, if the fertilizer manufacturers served by that utility are forced totally to cease production, the price of gas to the utility's remaining consumers will increase by as much as an additional $1/Mcf to make up for the resulting revenue deficiency.

Such adverse impacts of the loss of the fertilizer load are not limited only to the other consumers served by the utility. Using Oklahoma again as an example, in 1980 (the most recent year for which data currently are available) approximately 13 percent of all gas consumed in the state was used by the fertilizer industry. According to the Council of Louisiana Nitrogenous Fertilizer Producers, approximately the same historical percentage of relative use exists in Louisiana. In Arkansas, roughly 7 percent of the total quantity of gas consumed in the state historically has been used by Agrico alone. Give the size of the fertilizer industry, it is apparent that, as the industry is rendered increasingly non-competitive due to high gas costs, many gas producers will find the demand for their product even more depressed than currently is the case.

Williams Natural (and its customers and suppliers) are undergoing a similar experience. As a result of the continued erosion in the competitive condition of the Louisiana petrochemical and fertilizer industries, the current "market-clearing" price for many customers on Williams Natural's system has dropped (or soon may drop) to a level significantly below the NGPA §102 price level. Because the price of almost all existing intrastate supplies continue to track the NGPA §102 price level, however, the delivered price of gas to Williams Natural's consumers in many instances is forcing them to reduce their takes significantly.

Recently, despite its efforts, Williams Natural has lost for an indefinite period one of its oldest and largest direct sales customers due to the current high cost of gas. Other customers from time to time during the last twelve months also have significantly reduced their demand as the high price of gas (when compared with the conditions existing in those customers' sales markets) has rendered them non-competitive.

In response to these disorders, some intrastate pipelines (including a member of the Williams Natural group) have continued their purchases of "off-system" surplus interstate supplies (first begun in 1981). The continued availability of such supplies has facilitated the efforts of such pipelines to continue to provide service to their customers at economically practicable levels. Yet, for all of its efforts, Williams Natural finds itself largely unable to stabilize to any great degree the prices which its consumers must continue to bear for gas service.

Such developments have affected not only Williams Natural's customers but also its suppliers. Although Williams Natural was able to avoid take-or-pay problems during 1982 (in part by releasing some existing supplies), continued decreases in demand may necessarily result in such a development in 1983. Certainly, Williams Natural has curtailed its suppliers to levels which would not be necessary if substantial load loss had not occurred.

These developments are having an effect also on Williams Exploration. Currently, the dramatic decline in the demand for any type of gas is discouraging even relatively inexpensive new gas developments. In many instances, producers have so reduced their drilling efforts that reasonable men currently are predicting the reappearance of gas shortages in the foreseeable future. Moreover, the dramatic decline in demand for gas on most pipelines has resulted in massive curtailments in the level of gas takes, and, at its worst, the complete shut-in of most non-associated supplies already attached to such systems, thereby creating severe cash flow problems for many in the industry.

B. The Causes of These Problems

From an examination of the market from all of these perspectives, Williams is convinced that the inability of the gas market to respond in an economically rational manner to current economic conditions is the result neither of a lack of desire nor of effort on any one party's part, but, rather, is the logical consequence of a regulatory and contractual environment which has stifled the efficient operation of the mrket. Williams' experience has demonstrated that, no matter how diligent the effort of any segment of the industry to reassert the presence of economic realities in the gas market, the market will not respond until an external force acts finally to clear away the 35-years' accumulation of regulatory and contractual barriers which currently exist.

For example, given the size and importance of Agrico to each of its natural gas suppliers, in a free market economy it might be expected that, as Agrico considered ceasing (or significantly decreasing) its production due to high gas costs, its suppliers would immediately seek means by which to lower such costs. Agrico's experience is exactly the opposite, however. Although Agrico has remained in constant communication with its suppliers during the past few years and has constantly advised them of the effects which increased gas costs are having on Agrico's competitive viability, Agrico and its suppliers virtually are prohibited by existing contractual and regulatory barriers from adjusting their reltionship to reflect this current economic reality.

Williams Natural's experience is the same. Although Williams Natural has pursued every option reasonably available to it to meet the requirements of its customers at economic prices, it continually has been stymied by the operation of gas purchase contract provisions which, while reasonable in light of the environment which existed at the time of their execution, no longer reflect economic reality.

Williams Exploration's experience also confirms this explanation. While Williams Exploration recognizes that the renegotiation of existing contractual price provisions could lead to more realistic prices in the market, and, thus, in turn, a more stable demand for gas, more stable takes from existing sources of supply, and more stable incentives for future exploration and development, such a step faces substantial impediments. In Williams Exploration's experience, in the absence of such renegotiations being compelled on an industry-wide basis, producers who negotiate such price reductions individually will be potentially held liable for any negative financial consequences resulting therefrom in suits brought by their royalty owners, drilling fund partners and bankers.

IV. SOLUTIONS TO THE PROBLEMS PRESENTED BY THE GAS INDUSTRY

A. An Overview

It is apparent from Williams' experience that, during the past 35 years of regulation, the various segments of the gas industry have grown lax in including in their contractual relationships provisions which serve to ensure that such relationships continue to reflect the real-world economic considerations important to each party throughout the term of the relationship. It is Williams' experience that the failure to include such safeguards largely has been brought about by the increasing presence of regulation. Simply put, under the regulatory scheme which has heretofore existed, gas historically has been priced so far below its true economic value that neither the producer, nor the pipeline, nor the consumer has considered it either necessary or appropriate to expend their limited negotiating power in order to insert safeguards in their contractual relationships which force those relationships to reflect current market conditions.

Through the confluence of a number of factors, the gas market now has been brought face to face with real world economics. Gas no longer is an under-valued commodity in the market -- indeed, it fast is becoming an over-valued commodity. As a result, the different segments of the industry no longer can rely solely on the artifice of regulation to define the economic considerations which are important to their contractual relationships. If they are to function efficiently, each of these segments will have to take the responsibility for defining the limits of the economic considerations which are important to them explicitly within the terms of their contractual relationships.

It is Williams' belief that, in order to provide the different segments of the industry with the opportunity to inject such considerations into their relationships, governmental intervention will be required. As Williams' experience demonstrates, although each segment of the industry is fully aware of the nature of the problems faced by the industry, it either acting alone or in concert with other segments will be unable adequately to resolve the root cause.

While Williams argues that governmental intervention is required in order to commence the readjustment of the industry to current economic conditions, it nevertheless emphasizes that such intervention must be as minimal as possible and should be designed only to: (1) provide some immediate semblance of economic order to the industry so as to stabilize the industry while it undergoes the transition to current economic reality; (2) eliminate artificial barriers to the efficient economic operation of industry; and

(3) provide each segment of the industry with adequate tools to enable it to make the transition from its current regulatorily-constrained environment to economic reality. Williams believes that, once the artificial barriers to the market are removed and each party is permitted the opportunity to insert in its contractual relationships those provisions which enable it to protect the economic characteristics of such relationships most important to it, no usefulness purpose will be served by continued regulation.

Indeed, Williams believe that any continued regulatory constraints will only serve one day again to disrupt the industry as real-world conditions deviate from the assumptions underlying such regulatory conditions. As the gas industry has proven time and again during the past 35 years, no regulatory scheme -- no matter how flexible -- adequately can adjust to changes in market conditions sufficiently rapidly so as to prevent the creation of distortions.

B. The Solutions Proposed by S.615

As noted earlier, Williams believes that, in order fully to restore order to the gas market, legislation must (1) restore an immediate semblance of economic [illegible], (2) eliminate artificial barriers to the efficient economic operation of the industry, and (3) provide each segment of the industry with adequate tools to enable it to transition to a free market. Williams believes that S.615 meets these goals.

1. Restore an immediate semblance of economic order.

Williams's experience affirms that the gas industry currently is substantially disordered and is in danger of degenerating even further if some semblance of economic order is not soon restored.

In Williams' opinion, S.615 adequately responds to this condition. By imposing temporary restrictions on further escalations in the price of gas at the wellhead (new NGPA §111 [S.615, §301]), and on the delivered price of gas to consumers (new NGPA §60, [S.615, §101]), S.615 reduces the danger that further increases in the price of gas will serve immediately to undermine the basic framework of the industry (i.e., self-destruct the industry) before it has a chance under the provisions of S.615 to readjust to reflect more realistic economic conditions. Moreover, by restricting the operation of "take-or-pay" obligations at the wellhead (new NGPA §315 [S.615, §302]), and limiting the effect which they have on the delivered price of gas to the consumer in any event (new NGPA §603 [S.615, §101]), S.615 serves substantially to disarm one of the principle reasons for the rapid escalation in the price of gas on many systems.

The effect of these provisions on the industry admittedly will be mixed. While they should serve to stabilize the price of gas to the consumer, and thereby serve to preserve the economic viability of a substantial share of customer load, such provisions nevertheless will severely constrain (and perhaps even unduly penalize) some pipelines and producers. Such effects, however, will be offset, in part, by the preservation of load (and markets) which otherwise likely will be priced out of the gas market (perhaps permanently) and will thereby ultimately prove beneficial to such segments of the industry.

2. Eliminate artificial barriers to the efficient economic operation of the industry.

Williams' experience affirms that the gas industry in the past repeatedly has been disrupted due to the creation of artificial barriers between the interstate and intrastate segments of the industry, and between willing sellers wherever located and end users. These barriers significantly have restricted the efficient movement of gas from where available to where needed and have created disorders which could have been avoided had such artificial barriers not existed.

S.615 serves to alleviate many of these barriers and recognizes the need to assure pipelines and consumers equal access to needed gas supplies, wherever available. By disposing entirely of the concept of interstate "dedication" fostered under the Natural Gas Act, S.615 ensures that all supplies of gas will be able to flow to where needed without regard to the character of the purchaser (new NGPA §601(a)(1)(B) [S.615, §202]). By facilitating the transportation by any party on behalf of any other party of gas from where located to where required (new NGPA §311(a) [S.615, §401(a)]), and by permitting the sale or assignment of gas by any pipeline or distributor (either intrastate or interstate) to any other pipeline or distributor whenever such supplies are surplus to the selling pipeline's (and its customers') needs (new NGPA §311(b) [S.615, §401(b)-(c)]), S.615 encourages the movement of available supplies of gas from where available to where required without significant inhibition. S.615 further enables intrastate entities to acquire gas wherever available (whether inside of their "home" states or otherwise) without thereby also subjecting such entities to federal jurisdiction or causing them to breach any artificial impediments thereto which may exist in their contractual relationships (new NGPA §314 [S.615, §402]).

Finally, S.615 ensures further that the market position of pipelines does not serve to inhibit the further efficient operation of the industry, once order to the industry is restored. S.615 compels the utilization of available pipeline capacity whenever necessary to facilitate the movement of gas from where available to where required efficiently and without economic detriment to the transporter (new NGPA §§ 303 and 403]).

The removal of these barriers will permit the free flow of gas between markets whenever economic conditions require. By doing so, the substantial artificial barriers which have served to disorder various segments of the industry in the past will virtually be eliminated.

The effect of these provisions on the industry will be favorable. Consumers will be permitted the opportunity to access supplies which are compatible with the economic considerations important to them wherever such supplies are located. Producers similarly will find themselves free to negotiate supply arrangements with any entity requiring gas upon terms and conditions acceptable to such entities. Although some portion of their market power will be eroded, pipelines nevertheless will be permitted to extend their search for gas unrestricted by artificial regulatory impediments.

3. Provide each segment of the industry with adequate tools to enable it to transition to a free market.

Williams' experience affirms that the root cause of the current disorders which plague the gas industry is the failure of the various contractual relationships which are prevalent in the industry currently to include adequate contractual safeguards to protect the basic economic needs of the parties. If long-term economic order is to be restored to the industry, the insertion of such safeguards in contractual relationships is essential.

As noted earlier, because of the lax attitude which has developed as a result of years of pervasive regulation, such safeguards currently are absent from most such relationships. Thus, if such safeguards are to be inserted, the parties will need to be given adequate tools so as to provide a means and an incentive for the insertion of such provisions.

S.615 vests in the parties sufficient tools to accomplish this goal. By providing both the producer and purchaser with the ability to "market out" of a contract during a specified work-out period if the contract no longer reflects current market conditions (new NGPA §316 [S.615, §303]), S.615 ensures that each party to a contract is given both the incentive and the means by which to restore economic reality to the relevant contractural relationship. Of course, should the parties arrive at a private resolution of their differences without the need to resort to such tools, S.615 permits them to incorporate such a resolution into their relationship and thereafter operate free from further regulatory constraints (new NGPA §121(a) [S.615, §201]).

In either event, once the parties have resolved their differences, and thereby restored economic reality to their contracts, the remaining regulatory overburden becomes useless and is stripped away. Thereafter, the industry is left to the rigors of the free market by the "deregulation" of the sale of all gas (new NGPA §§121, 601(a)(1)(B) [S.615, §§201-02]). More importantly, the market is left to adjust freely to changes in economic conditions (both upward and downward) and is left unconstrained by artificial regulatory barriers.

The effect of these provisions on the industry will be positive. Consumers will be able to obtain supplies which are fully compatible with their particular economic considerations under terms and conditions which will ensure that such supplies always are reflective of such considerations. Pipelines will be given the opportunity to reorder their markets so as to safeguard their customers from increases in price, or interruptions of service, which may be beyond the ability of such customers to accept. Producers will be given the opportunity to find markets which provide them with a stable and adequate return at prices which are sufficient to elicit the supplies which will be required by the consumers served thereby.

V. PROPOSED REFINEMENTS TO S.615

While Williams thus is encouraged by the provisions of S.615, I want to note that we believe that the bill needs to be further refined in four important respects if it fully is to realize its goal of reordering the gas market.

A. Consumer Revisions

The first two refinements which I propose are from the perspective of a gas consumer. They are: (a) to extend the "consumer protection" provisions of the bill to include intrastate consumers; and (b) to place in the hands of all consumers (both the interstate and intrastate) the same market reordering tools as are placed by S.615 in the hands of pipelines and producers.

1. Protection of Intrastate Consumers.

The Committee should be aware that intrastate consumers are an important segment of this nation's industrial base. According to testimony previously presented before this Committee, in excess of 35 percent of the nation's industrial-related requirements for natural gas currently are being met from intrastate sources of supply. Intrastate sources of supply are even more important to the basic petrochemical and agricultural industries. We are advised that the primary petrochemical manufacturing facilities located in Louisiana and Texas alone represent 70 percent of this vital industry's total domestic productive capacity and that in excess of 60 percent of the nation's total domestic nitrogenous fertilizer capacity is located on intrastate systems.

These intrastate consumers have been as adversely affected by the disorders which currently plague the natural gas industry as any in the nation. Within the past two years, vast portions of the fertilizer industry located in Louisiana (which alone represents in excess of 30 percent of total U.S. capacity) have been rendered non-competitive due to high gas costs. While that portion of the fertilizer industry located in Oklahoma has only recently been forced to face similar problems, recent proceedings before the Oklahoma Corporation Commission have revealed that increasingly higher gas costs also are about to render those facilities economically non-viable. Many of the same conditions currently are being faced by others in the chemicals industry served from intrastate sources of supply.

While S.615 recognizes the current disordered conditions faced by industrial and other consumers served indirectly from interstate systems and affords them certain protections from higher gas costs during the transition of the gas industry to a free market (new NGPA §603 [S.615, §101]), no similar protections are afforded intrastate consumers. Moreover, while S.615 affords interstate consumers the ability prospectively to acquire supplies in the field and arrange for their transportation to their facilities without difficulty (new NGPA §317 [S.615, §403]), no similar provision is made for intrastate consumers.

As we have seen under both the Natural Gas Act and the Natural Gas Policy Act, serious competitive disparities arise when artificial distinctions are made between gas producers, pipelines and consumers based solely on whether they are served from interstate or intrastate systems. Accordingly, we urge the Committee as it proceeds on this issue to resist the temptation to continue to make artificial distinctions between the rights and protections afforded interstate and intrastate consumers. Specifically, if S.615 is the vehicle that the Committee uses to proceed on this issue, we urge the Committee to broaden both section 101 (new NGPA §603), and section 403 (new NGPA §317) to include equal protections and rights for intrastate consumers, with the authority to enforce such provisions vested in the appropriate state agencies.

2. Reordering the Pipeline-Consuemr Relationship.

The Committee should be aware that, just as there exist "indefinite price escalator" and "take-or-pay" obligations between pipelines and producers, similar obligations exist between pipelines and end-users. The historical derivation of such clauses in pipeline-end user contracts is the same as is the case for their existence in producer-pipeline contracts. Simply put, under the regulatory scheme which has heretofore existed, gas historically has been priced so far below its true economic value that neither the producer, nor the pipeline, nor the consumer has considered it either necessary or appropriate to expend any degree of their limited negotiating power in order to insert safeguards in their contractual relationships which force those relationships to reflect current market conditions.

The gas industry now has come to realize that future relationships must include contractual provisions which will insert into those relationships market realities. No longer are the parties able to rely solely on the artifice of regulation to define the economic realities which are important to the relationship of the parties. S.615 only goes half of the way in enabling the relevant parties to revise their current contractual relationships to reflect these conditions, however. It leaves totally untouched the relationship between the pipeline and the consumer.

Without providing for the renegotiation of the pipeline-consumer relationship at the same time as the producer-pipeline relationships is being renegotiated, the Congress may find that, for all of its efforts, the goal finally to impose market realities on the gas industry will remain unmet. Pipelines wtih contracts obligating their customers to "take-or-pay" for gas and pay rates based upon "indefinite price escalator" provisions will have little real incentive to take "tough" positions in the renegotiation of their gas purchase contracts with producers. Even if such pipelines are inclined to take "tough" positions, they might forego the interests of certain of their customers if they consider it necessary to meet the needs of their remaining customers.

Certainly, pipelines which have contracts obligating their customers to "take-or-pay" requirements will be little inhibited by the "contract carrier" provisions of S.615. Even if a customer wants to utilize the "contract carrier" provision, it still will be bound to meet its "take-or-pay" obligation to its pipeline supplier. Thus, consumers seeking to obtain contractual relationships which better safeguard the economic considerations important to them will be severely inhibited.

Accordingly, we urge the Committee as it proceeds on this issue to create the opportunity for the full insertion of market forces into the entire gas industry. Specifically, if S.615 is the vehicle that the Committee use to proceed on this issue, we urge that the Committee broaden both section 302 (new NGPA §315), and Section 303 (new NGPA §316) to contemplate renegotiations between pipelines and end-users.

B. Pipeline Revisions

The next two refinements which I propose are from the perspective of a gas pipeline. They are: (a) to impose equivalent terms and conditions on intrastate and interstate pipelines alike when they are engaged in NGPA §§311(b) and 312 transactions; and (b) to ensure that all artificial barriers to the equal access of gas supplies by intrastate entities are removed.

1. Equal Treatment of NGPA §311(b) Sales and NGPA §312 Assignments Made to Intrastate Purchasers.

At the time of the passage of the NGPA, there existed a surplus of gas in the intrastate market and stark deficiencies of gas in the interstate market. The Congress found that artificial regulatory barriers prevented the flow of such gas freely from where available (the intrastate market) to where required (the interstate market) and, in order to relieve these barriers, enacted sections 311(b) and 312 of the NGPA.

With the passage of the NGPA, the location of deficiencies of economic gas supplies has shifted from the interstate to the intrastate market. While NGPA §§ 311(b) and 312 alleviated the substantial regulatory barriers which theretofore had prevented the flow of gas from the intrastate to the interstate market, no similar mechanism was put in place to facilitate similar transactions in reverse. Thus, despite the passge of the NGPA, there continues to exist today an economic need for gas in one market (the intrastate market) and available supplies in another (the interstate market), but significant regulatory impediments to so transferring such supplies.

Sections 401(b) and (C) of S.615 seek to alleviate these remaining regulatory barriers by providing, in essence, authority for "reverse" NGPA §§ 311(b) and 312 transactions without significant regulatory consequence thereby resulting. Williams Natural is concerned, however, that, as currently written, these provisions leave open the possibility that such "reverse" transactions will be authorized under discriminatory terms and conditions.

As currently enacted, NGPA §311(b) compels intrastate pipelines making sales to interstate pipelines to do so based upon the intrastate pipeline's weighted average cost of gas. In essence, this provision forces intrastate pipelines to treat sales made to interstate pipelines equally for pricing purposes with those made to such intrastate pipeline's intrastate customers.

S.615 provides no such protection in reverse for intrastate purchasers, however. As proposed by S.615, "reverse" NGPA §311(b) sales will be made at whatever "just and reasonable" rate for such sales is authorized by the Federal Energy Regulatory Commission (FERC). Recent experience with the FERC's current "off-system" sales program demonstrates that the FERC currently considers it neither unjust nor unreasonable to assess intrastate consumers significantly higher rates than interstate consumers.

If the Congress is to ensure that full equal access to available supplies of gas is accorded to intrastate consumers, and that all further forms of discrimination between interstate and intrastate consumers cease, it must provide that equal treatment will be accorded whenever similar types of transactions are made between the two markets.

Accordingly, we urge the Committee as it proceeds in its deliberations to ensure that no artificial distinctions between interstate and intrastate consumers remain after the passage of any further legislation in this area. Specifically, in this instance, if S.615 is the vehicle that the Committee uses to proceed on this issue, we urge the Committee to include a requirement that equal treatment be afforded interstate and intrastate purchasers alike in any NGPA §§ 311(b) and 312 transactions.

2. Removal of All Artificial Regulatory Impediments to Equal Access.

During its review of S.615, Williams Natural has noted two apparent oversights (both contained in S.615, §402) which, although seemingly insignificant, may nevertheless serve materially to inhibit the full functioning of a free market if left uncorrected.

The first such oversight appears to occur in Section 402(a) of S.615 (new NGPA §314). Section 402(a) extends the policy (currently embodied in NGPA §314) to void as against public policy certain contractual provisions which currently are in use which artificially serve to inhibit the full operation of the market.

While Williams Natural fully supports the policy underlying this provision, it notes that, within its experience, the language proposed in S.615 to meet this goal is not sufficiently broad so as to remove all artificial barriers to the full operation of the market. The artificial contractual barriers which Williams believes are left unaffected are those which prohibit the transportation (rather than sale) of gas under a transportation contract if such gas has been commingled with other gas which has been transported in interstate commerce. If left unaffected, such contracts will serve artificially to inhibit the transportation of gas by one intrastate pipeline for another (or an end-user) when the gas so to be transported has been commingled with gas which has, in turn, been transported in interstate commerce.

The second oversight noted by Williams appears to occur in Section 402(b) of S.615. Section 402(b) introduces a policy protecting intrastate pipelines and local distribution companies from unnecessary federal jurisdiction if their transactions, despite the fact that they may extend in some part beyond state boundaries, are nevertheless intrastate in character. The activities included in new NGPA §601(c)-(3) (S.615, §401(b)) also are important because they control when certain artificial impediments to the full functioning of the gas market contained in other than first sale relationships are dismantled by new NGPA §314 (S.615, §401(a)). See new NGPA §314(b)(2) (S.615, §401(a)).

While Williams Natural fully supports the policy underlying section 402(b) (new NGPA §601(d)-(e)), it would note that, within its experience, it believes that the precise provisions of the section are not sufficiently broad so as fully to include all those transactions which should be similarly treated. The specific transaction which Williams believes inadvertently has been so excluded from treatment as a "covered transaction" (new NGPA §601(d)(5)) is the sale of gas pursuant to Section 7(c) of the Natural Gas Act to any person not subject to the jurisdiction of the Commission solely by reason of Section 1(c) of such Act. Williams Natural notes that, if left uncovered, the purchasers of gas under such transactions both will be artificially restricted in the arrangements which they may make for the purchase of new gas supplies located outside of their "home" state and will be left unprotected by the provisions of new NGPA §314 (S.615, §402(a)).

In order to remove this artificial impediment to the functioning of a full free market, Williams urges that the Committee broaden new NGPA §601(d)(5) (S.615, §402(b)) so as to include within the definition of a "covered transaction" the type of transaction described above.

VI. SUMMARY

Williams' experience is that the current regulatory scheme affecting the natural gas market seriously is disrupting the market to the detriment of consumers, pipelines and producers alike. Williams believes that legislative changes necessarily must be made to this scheme if order is to be restored to the market. Williams believes that, with the refinements discussed herein, S.615 offers the best solution.

The CHAIRMAN. Senator Johnston.

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Chairman, I want to welcome these great witnesses here, especially those from Louisiana.

The CHAIRMAN. Might I interrupt just long enough to indicate that we are pleased to have been able to rearrange the appearance of the panelists, so they might be here today so that you could say that to them.

Senator JOHNSTON. And I thank the chairman for doing that. And when I think that I almost had to be on the floor to defend an amendment in which Louisiana had an interest, I shudder. If you had all come, and I had missed you, I really would have had egg on my face. But I am glad that we are both here at the same time.

Mr. Harmon, suppose we are not able to change those provisions with respect to the gas cap. The gas cap is what you are principally concerned about. You have not expressed any concern about the passthrough provision.

Mr. HARMON. We do have concern with the passthrough.

Senator JOHNSTON. Excuse me.

Mr. HARMON. Our three main concerns would be the gas cap, the passthrough, and to eliminate any kind of extension beyond January 1, 1986.

Senator JOHNSTON. OK.

Mr. HARMON. So those are our three basic concerns.

Senator JOHNSTON. All right. Suppose that those provisions may remain in the bill, what would LAIPRO's advise?

Mr. HARMON. My guess would be, if the bill stayed in its current form without taking care of some or all of those provisions, that we would not support the bill.

Senator JOHNSTON. You would urge the President to veto the bill?

Mr. HARMON. Yes.

Senator JOHNSTON. Now suppose that we are able to come up with an amendment with respect to the gas cap which would eliminate the renegotiated contracts from the gas cap. As you know, it is now a weighted average of new contracts, which would be the market price and renegotiated contracts.

And I agree with you that to include renegotiated contracts would give you a cap well below the section 102 price. How much below, nobody knows, but I would expect a long way below.

But suppose that we are able to eliminate from that configuration of a weighted average the renegotiated contracts, what do you suspect that your advice would be then?

Mr. HARMON. If renegotiated contracts were not included in the cap, I think that we would be in support of that section of it, no doubt.

Senator JOHNSTON. And on the passthrough?

Mr. HARMON. On the passthrough, our concern there is that you have got to let the market somehow have some kind of mechanism to seek a free-market value prior to a decontrol date.

Senator JOHNSTON. Suppose we fix the passthrough by, rather than putting it at the pipeline average acquisition cost, it would be at the national-average acquisition cost, and anything above that you would have to seek FERC approval.

Mr. HARMON. That would be more reasonable, yes.

Senator JOHNSTON. And you suspect that LAIPRO could go along?

Mr. HARMON. I suspect that they would support that.

Senator JOHNSTON. Fine. Thank you, very much.

Now, Mr. Terrill, can you tell me how much rollback there would be in your view under this cap. There would be a rollback in prices from section 102, do you not agree?

Mr. TERRILL. Yes, sir, I do agree. And we are making some purchases in the State now that would qualify for 102 prices in the $2.75 to $3 range. So 10 to 15 percent perhaps rollback from 102 prices.

Senator JOHNSTON. What is 102 now; $3.34, is it?

Mr. TERRILL. Yes, that is correct.

Senator JOHNSTON. And you are making purchases now at $2.75?

Mr. TERRILL. We are making some new purchases, yes.

Senator JOHNSTON. Are any 102 contracts getting the full 102 contract price?

Mr. TERRILL. They are. And contracts are still based on our estimate of reserves, the location, and proximity to our existing pipeline system, hence the cost at which it would ultimately get to market. So you cannot just look at wellhead price, and say that all wellhead prices ought to be the same.

Senator JOHNSTON. Well, when you are talking about a rollback to the $2.75 price, do you not think that it would be substantially more than that, if you include in the weighted average for the gas cap renegotiated 104 contracts which would, I think, be renegotiated in stages, or slowly renegotiated up to the market price?

Mr. TERRILL. As to the industry, it is possible, I think, Senator. In our own particular case, because we already essentially have all of our gas at 102 prices. There is not much ability on our part to just slowly move prices one way or the other with some lower price gas.

We have no cushion that would adversely, to the producer at least, weight average that cost down. I think that that is true, certainly, with the interstate pipeline.

Senator JOHNSTON. I know that that is true with the intrastate. You are essentially at market right now. And you are really restrained more by No. 6 or No. 2 fuel oil, as the case may be, than you are by NGPA, are you not?

Mr. TERRILL. We are an excellent example of the competitive forces at work with alternate fuels, and the abilities particularly of industrial consumers, which we largely serve, to compete with other suppliers of like goods. And we are at what we consider and see to be the market clearing price with our costs now.

Senator JOHNSTON. I would like to ask a question to both Mr. Terrill and Mr. Greehey. You are both intrastate pipelines. The competition is the interstate pipelines. I take it that you both are well familiar with the competition, how they do business.

Mr. TERRILL. We have seen the enemy.

Senator JOHNSTON. Is it fair to say that intrastate pipelines are leaner and meaner than the interstates, leaner at least?

Mr. TERRILL. I think that it is fair to say that; yes, sir. We have had to be more competitive at both buying and selling through the years, post-NGPA and pre-NGPA. And part of the example that I presented in my testimony in December before this committee showed what happened on our pipeline system and other intrastate pipelines before the NGPA was passed.

And you can see prices rising and falling through the course of those years that we showed you in response to the economic forces at work.

Senator JOHNSTON. Mr. Greehey, what do you think about that?

Mr. GREEHEY. We have been a little more fortunate in Texas than Louisiana, because there has been a lot of 102 gas found. So we have been successful in replacing reserves that we have sold.

In the case of premium gas, such as tight gas, we just have not been able to beat the interstates.

Senator JOHNSTON. My question really has to do with the efficiency of an intrastate pipeline versus the interstate. One of the parts of this bill that is really revolutionary, and had received very little attention, has to do with the contract carriage, which for the first time would put the interstates into real competition.

And also, to some extent the passthrough, but principally that contract carriage provision. And what I am asking you to do is to comment on the interstates.

Are they bloated, or are they fat, are they inefficient, could they compete with you on sales and purchases and the way that they do business?

Mr. GREEHEY. Well, the interstates have always operated in a free market prior to the enactment of the Natural Gas Policy Act. The interstates have not. So I think that they would have to make a lot of adjustments into their management philosophy.

Senator JOHNSTON. What kind of adjustments would they have to make?

Mr. GREEHEY. I think that they would have to reduce costs, and operate more efficiently like the intrastates have had to do.

Senator JOHNSTON. If you make a mistake and make a dumb purchase for very expensive gas, your stockholders have to bear some of that risk, do they not?

Mr. GREEHEY. That is correct.

Senator JOHNSTON. And what does an interstate do?

Mr. GREEHEY. I guess they go for a hearing and pass it through.

Senator JOHNSTON. There is no guess about it, is there?

I do not know. Maybe you do not want to talk about the competition.

But is that not really a revolutionary provision here, that contract carriage, and is that not a good provision?

Mr. TERRILL. Let me finish up the statement about the competition. The interstates are very capable of being very competitive. And they have been competitors of ours primarily at purchases through the course of all these many years, even pre-NGPA days. And we respond as intrastates very much to what pattern they set in the pre-NGPA and post-NGPA times.

You cannot see these well, but they are attached to our previous testimony. And I will see if you do not have that now, that we send it on up. But this red line on the end is my gas cost, LIG's gas cost as compared to the other interstate pipelines that work the same area that we do in purchasing.

This aberration occurred since NGPA. Pre-NGPA, we were very close, just a fraction of a cent would have separated us during those days. The NGPA discriminated against intrastate pipelines in the setting of prices for old gas—104 on the interstate side, and 105 on the intrastate side.

And I have in our system better than a 50-percent old gas by volume available. Theoretically, I ought to have better than a 50-percent cushion, if I had had the same treatment than the NGPA afforded the 104 gas. But we did not.

Our 105 gas, the equivalent of that, has gone to market price, the equivalent of incentive price.

Senator JOHNSTON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Nickles.

Senator NICKLES. Thank you, Mr. Chairman.

I thank our panelists. I regret that we do not have more Senators. And again, I will cover for them to some extent, because we do have a lot of things going. But your statements, I think, are well targeted.

Mr. Harmon, as it is right now, because of the cap and the pass-through provisions, you would not support the bill in its present form. What about the rest of our panelists. Would you state your position on the bill as it is now.

Mr. WALZEL. I think that we would stay with the bill. Because the important thing is that after a fairly short length of transition time, you are into a free market. And there are some imperfections in that transition. And they are going to be there.

There are some things that we would like to see a little bit different. But the main concept of getting to a free market gas, we think is of ultimate importance.

Senator NICKLES. In the long term?

Mr. WALZEL. Yes; it is still there. So I think that we would probably, it would be my guess, stay with it.

Senator NICKLES. Is that shared by the rest?

Mr. TERRILL. Yes.

Senator NICKLES. I might follow up, and Mr. Harmon, Mr. Terrill, or Mr. Jones, or anyone, on this intrastate and interstate dilemma, which we heard some statements yesterday from some people not wanting to have dual market.

Is it not a fact that we had a dual market in the past prior to NGPA, because we had deregulated gas on intrastate markets, and regulated on interstate. And now that we have regulated intrastate, because Mr. Terrill of what you said, interstates had the old 104 that was held down, that they were at a competitive advantage vis-a-vis the intrastates today.

Is that correct?

Mr. TERRILL. Yes, sir, that is exactly correct.

Senator NICKLES. So in the law as it is today, we have really some inequities and some disadvantages to the intrastates?

Mr. TERRILL. Exactly. I think that the NGPA was well intentioned in what it attempted to do to correct what it perceived as a two market system pre-NGPA. It overshot the mark tremendously.

Senator NICKLES. Well, prior to NGPA, one could say, and I guess that I would advocate, that intrastates had a better deal, because we were deregulated, and they were not. And even though we paid more in the intrastate systems in many cases, I think in Oklahoma, and you mentioned your figures and they were close, intrastates in Oklahoma paid substantially more than the interstates.

We also had adequate supplies of gas in relationship to the rest of the market. And so we had an advantage, as I would say. Some would say that it was a disadvantage, because we were paying more for gas.

But right now, we do have a dual system. Now if we followed the administration's proposal, not talking so much about the interim period of getting them, but beyond getting them, and Mr. Harmon, you might comment on this, after at least we would get there, you would eliminate that inequity.

Would that not be the case? You would have a market for gas, and you would not have the built-in inequity that is in the system right now.

Mr. TERRILL. That is true. And I may interject, I believe that even before 1986, there would not be the development of that market to the extent that it is being discussed.

First, as I pointed out, we are already at market clearing prices. You would have to presume that our customers could pay higher than market prices, if we were to bid up the price above market price. And that is not the case.

Our customers cannot pay more than market clearing prices. We discovered that very well over the last 18 months.

Senator NICKLES. So if you went out and bid on some LNG, or some deep gas in the $7 range, what you are telling me is that you could not sell it?

Mr. TERRILL. Even 102 gas has become a problem.

Senator NICKLES. You cannot sell gas at $3.30?

Mr. TERRILL. It is partly because of the recession, I think. But there are some industries, and anhydrous ammonia would be one, that have a very difficult time competing at $3.30 right now, because of the imported problems.

Senator NICKLES. Mr. Jones, the fact that you brought up that the ammonia plants consume a great amount of natural gas, an enormous amount of natural gas—I was surprised, and I guess impressed with the amount of gas that you are a consumer of—so you are coming from the consumer standpoint.

And you stated very emphatically that you were really for this bill, because it was going to reduce your gas cost.

Mr. JONES. We are fully convinced that that is the situation. The anhydrous ammonia industry is not subject to the interfuel competition that we talked about generally as being the definition of the market clearing price for natural gas. It is really subject to competition from imported ammonia.

And we will probably become increasingly subject to that competition. It serves a market that right now suffers severe liquidity problems. Things are underway in an attempt to solve those problems for the farmer. But he also faces relatively low commodity prices.

Senator NICKLES. So the general marketplace——

Mr. JONES. The general marketplace is under very, very severe pressure.

Senator **Nickles**. And that is what is holding the price down, and not No. 2, No. 6?

Mr. **Jones**. Those are really not significant factors in that total scenario. But at the market clearing prices, at the current 102 prices, it still leaves the fertilizer manufacturer under very, very severe market pressure. And we think that it will continue.

But we are convinced that in its present form, this bill will result in lower natural gas prices, and permit that industry and other similar industries, who are large users of natural gas, not necessarily subject to the interfuel competition as far as its marketplace clearing price, that it will leave those industries also in a better position.

Mr. **Harmon**. Senator, let me go back to your other question then. Let me make it clear that we favor totally and completely——

Senator **Nickles**. Let me get right back to you, if I do not run out of time. But I want to delve just a little bit. One of the first panels today said that the feedstock industry, industries that use natural gas as a primary feedstock, have no incentive really to hold it down, because they do not have the competitive fuels.

You are saying that that is incorrect?

Mr. **Jones**. The marketplace is defining the competition for the end product of the ammonia industry, and other feedstock-oriented industries, from my point of view.

Senator **Nickles**. In your case, you are competing with what, Mexican imports?

Mr. **Terrill**. Mexican imports, primarily, at the present time. And there is the potential of imports from other offshore sources.

Senator **Nickles**. Thank you.

Now, Mr. Harmon.

Mr. **Harmon**. We do very much support the decontrol of natural gas, the old and new gas. We feel like the gas cap, where you lower new gas prices from its current level to a gas cap, is not in the best interests. We feel like if you could freeze current existing gas contracts at its level on date of enactment, and then——

Senator **Nickles**. All contracts?

Mr. **Harmon**. All existing contracts at date of enactment. And treat it the same as 107 gas. And as the gas cap increases, when it reaches that level of the existing contract price, then it would follow the gas cap until January 1, 1986.

Senator **Nickles**. I might add to that. I might remind you that there are probably some other things. I concur with your apprehension. And no one knows exactly. We have been debating where that gas cap would come in. You have made a point that you feel that the gas cap would come in substantially below market price.

And, Mr. Terrill, could you tell us what in your opinion the market price for gas is now, since you stated that you are right on it, given the fact that the state of the industry and so on. You mentioned a figure before.

Mr. **Terrill**. No. 6 oil on the gulf coast is generally the competitive force with respect to alternate fuels.

Senator **Nickles**. What is that price?

Mr. **Terrill**. In the spot market, waterborne would be about $4, and perhaps slightly under that in Louisiana on the Mississippi

River. And the advantage of waterborne there has some effect on this.

We serve, though, probably the single largest number of anhydrous ammonia producers of any other single pipeline of which I am aware. And there are forces that Mr. Jones mentioned that are adversely affecting that below those levels.

Senator NICKLES. So, Mr. Harmon, you are coming, and you are saying that if you have a producer, and he has a contract right now onshore, or offshore, or whatever, and you are saying he is selling it for $3.20. And by the gas cap figuring in the renegotiation of old, and let us say that it came out at $2.75, or $2.50, that you have got a lot of people who borrowed money on that $3.30, and you would not want to see them put out of business because of that?

Mr. HARMON. That is very important to independent producers.

Senator NICKLES. I can understand the concern that you have. I share that concern. But I think that we need to come up with something, and possibly a redefinition of gas cap may be able to work that around. Hopefully, we can.

But I think that it is awfully important, as Mr. Walzel said, that we move toward ultimate deregulation of all gas.

Mr. HARMON. And I agree to that.

The CHAIRMAN. Mr. Harmon, you indicated earlier, in response to a question that if the bill were not changed you would recommend that the bill would be vetoed.

Would I understand——

Mr. HARMON. No; I said if the bill was not changed as far as the gas cap and the passthrough is concerned, and if there was an extension of the date beyond January 1, 1986, we would not support the bill.

The CHAIRMAN. You prefer to stay under NGPA?

Mr. HARMON. Well, that is—NGPA runs its course as of January 1, 1985. Independent producers hold very little old gas. We could very strongly make the case that the regulation is not in the best interests of the independent producers because of that because we could sell our gas at an uncontrolled market price, while old gas remained under the controls.

We think that is irresponsible, however, and we do support deregulation of both old and new gas. I think it is the way that we are going to get there to do it.

I think the President should be commended. You should be commended, and the Department of Energy should be commended for offering S. 615 as a step in accomplishing that.

I think it has got to have some clarifying language in it, but it is a good step of accomplishing that, to make January 1, 1986, a decontrolled date.

The CHAIRMAN. Some of us who watched what happened last November and December with some concern, because it seemed to me that we were not being offered the opportunity to continue under NGPA to the decontrol date set for the classes of gas which would be decontrolled under NGPA.

We were being offered as an alternative the reimposition of controls, and I suspect that none of you at that table would have welcomed that at all.

I think that is still a substantial possibility. I doubt very much that Congress is going to sit here and do nothing over the next year or two, so we are looking at——

Mr. HARMON. And as I stated——

The CHAIRMAN. We have work to do.

Mr. HARMON. We are very much opposed to the extending, freezing prices at a past level or extending this beyond the January 1, 1986 date.

The CHAIRMAN. Yes, sir.

Thank you.

Senator Johnston, do you have further questions?

Senator JOHNSTON. Yes.

Mr. Terrill, I know that in the intrastate States you are getting a lot of gas down there now under interruptible contracts.

As the economy improves, the demand for gas goes up or the bubble is gone, just what would happen under NGPA?

Mr. TERRILL. We will be back to first half 1981 conditions, where the State supply to the intrastate pipelines was deficient because we were unable to compete for the new supplies that were there.

We were being outbid because our market did not pay above-market prices, and we were competing and now are competing with those who have the cushion and would continue to offer above-market clearing prices, or the potential would be there.

We would be forced to go beyond our State borders or we would go into curtailment. That would be my opinion.

Senator JOHNSTON. Now, you can go beyond the borders now under the FERC decision, if you can find them?

Mr. TERRILL. Louisiana intrastate gas cannot go beyond the State borders.

Senator JOHNSTON. But if you buy from an interstate——

Mr. TERRILL. We have within our family of companies and have done so in that period of time that I just described, early 1981, outside of the State to import gas into our State—that is correct.

It is totally interruptable and is subject to curtailment based on the pipeline suppliers that we acquired this from, needs for their own system.

Senator JOHNSTON. All right. In other words, you would see a curtailment kind of situation or firsthand 1981 situation where there was curtailment—or was there curtailment——

Mr. TERRILL. There was potential for curtailment but for the fact that we got gas from outside the State during that period of time.

Senator JOHNSTON. Now, most of your load is an industrial load, isn't it?

Mr. TERRILL. Ninety-five percent of ours is, yes.

Senator JOHNSTON. And that is mainly petrochemicals, big industrial plants along the Mississippi River that supply feedstocks, plastic, and rubber, et cetera, for the rest of the country?

Mr. TERRILL. Anhydrous ammonia, and the timber industry, is a large part of it as well.

I ought to mention, Louisiana utilities are still largely dependent upon natural gas for their power generation needs.

Senator JOHNSTON. Now, I ask this to Mr. Terrill or anybody else who would like to comment.

As of September 1982, which is the last month for which I have figures as set forth in the Natural Gas Monthly, the weighted average wellhead price for natural gas was $2.53.

Now, could we expect the gas cap to be at about $2.53 as adjusted by inflation since September 1982, under the present bill without change; or would it be different and why?

Mr. WALZEL. I think it is hard to guess at what the gas cap would be under the bill as long as it has renegotiated contracts in it, because there is no way of guessing until we see what happens, as to what type of renegotiations and what volume the renegotiations are going to be in.

Senator JOHNSTON. Well, considering that renegotiated contracts, particularly section 104 contracts would be in there, isn't it fair to say that a price around that level—$2.53, adjusted maybe for inflation?

Mr. WALZEL. I think it would be that or lower.

Senator JOHNSTON. That or lower?

Mr. TERRILL. I would agree with that, yes.

Senator NICKLES. Be what?

Mr. TERRILL. That it would be in the range of this $2.50. The potential is there for lower, not because of anything that the intrastate pipelines would do, because we don't have the ability to—we don't have the low-cost gas to throw into this mix by renegotiation, so it is impossible for me to predict what the interstates would do with that; but I think it is conceivable that it could even, in fact, be lower.

Senator JOHNSTON. Mr. Walzel and Mr. Terrill both say $2.50 or lower, and you say, there is a potential for a good bit lower, Mr. Terrill?

Is that correct?

Mr. TERRILL. Again, depending on how much section 104 moves at any particular time, on renegotiated contracts.

Senator JOHNSTON. It depends on a lot of things. We are getting some ballpark figures here.

All right, Mr. Greehey, do you agree with that?

Mr. GREEHEY. Yes, I think the price would go down, and it would be primarily because of the gas cap, which would cause section 102 prices to roll back.

Senator JOHNSTON. But the $2.50 range is a fair estimate? Would you say that as well, Mr. Jones?

Mr. JONES. I am not as certain that the price would move down as fast as the other gentlemen seem to feel it. The interstates are going to be the actors in that game. I believe they are going to turn their attention to the high-cost gas supplies first.

So, I can't disagree with the ultimate level to which the cap may drop. We really haven't decided internally where we think that number might be.

Senator JOHNSTON. But you do think it would drop substantially?

Mr. JONES. I think it will drop down, yes.

During the course over the period where the caps are——

Senator NICKLES. Senator, were the other members—were you figuring too at the same time that you would be bringing in section 104, renegotiating section 104, that you would also be renegotiating, say, section 107?

Mr. **Terrill**. I was, but a large number of those 107 contracts have found their way down, in the past months. I am not sure they would be as great a factor as they might have been this time a year ago.

Senator **Nickles**. You don't think that the fact that they would——

Mr. **Terrill**. They will come down.

Senator **Nickles** [continuing]. The fact that the section 104 is coming up that they would equalize around the figures that you are talking about, or that the cap would still be quite a bit less than say section 102?

Mr. **Terrill**. Again, it depends on—you are talking about the first 6 months, or at the end of the 2- or 3-year period? I think it will tend toward what you are describing by the time 1986 arrives, or 1985 even.

Senator **Johnston**. By the time a lot of Mr. Harmon's clients are broke at $2.50.

Now, Mr. Jones, you stated in your written testimony that intrastate should be subject to the passthrough.

I understand—somebody said that you may have changed your mind in the meantime.

Mr. **Jones**. We are restudying that issue, and we may confirm that conclusion, but we are looking further at the characteristics of the market and so on, the contract situations that exist.

We would like the opportunity to readdress that issue at a later time.

Senator **Johnston**. I would suggest to you that Mr. Terrill's statement makes a strong case on that, that they are already virtually at the market price.

Mr. **Jones**. I don't disagree with that, at all.

If you perceive market price or define market price in terms of the ultimate fuel competition, there is no doubt about it, we are at ultimate fuel prices.

Mr. **Terrill**. Senator, may I make one point there with respect to producer concerns about the price?

I think that at those levels, with the improvement in the economy, the producer is going to be running a greater volume of gas than he currently runs at this higher price; and I think he could conceivably be even better off under that scenario.

Mr. **Jones**. I would agree with that, very definitely, because one of the major factors that affect your end result economics, looking from our perspective as a producer, is the curtailment, and all of our gas that we produce is severely curtailed; it is back to a minimum at this point in time.

Senator **Johnston**. Let me, before I ask my last question, let me invite any members of the panel who have some language if you would like for us to see, please send it to us because we are examining all kinds of alternatives to solve what I personally see as the two biggest problems—passthrough and cap, and there are other problems. The cap or the passthrough as applied to NGPA—applied to intrastate.

I also had some written questions. Let me ask, Mr. Terrill, if you can give us a gas supplied demand scenario for the next 2, 3, 4, years, however far that you can see clearly in the future.

Mr. TERRILL. We have, as our basic assumption that the economy will recover to some level, if not 100 percent of what it was in early 1981, to some fair approximation of that by the end of 1984—that is, we will be moving from where we are now, to a fairly ginned up economy in our State, at least, by the end of 1984.

Senator JOHNSTON. The gas bubble will be gone by that time?

Mr. TERRILL. If that occurs nationwide, to the extent that it occurs in Louisiana, it would be my opinion the gas bubble would, if not having burst, would be recognized to have diminished.

Senator JOHNSTON. Are we going to get those stacked rigs drilling again?

Mr. TERRILL. We are doing everything that we can, and I think we will get them back. The incentives, I think, are still there. I am finding that producers are looking for shallower prospects to be drilled, and closer in plays that will accommodate the prices that can be paid today, and as that improves, and the economy improves, and supply and demand relationships change, I think we will be back to those kind of things.

Senator JOHNSTON. If you freeze and roll back, I take it the number of rigs stacked would increase?

Mr. Harmon, I see you shaking your head, yes.

Mr. HARMON. I agree with that, but I agree with Jim to the point that you are seeing a lot more shallow production, particularly in Louisiana. Very few independent producers operate in the Tuscaloosa in the first place, and very few of them have section 107 gas. Of those who did must have filed chapter 11's.

Most of our activity is in shallow production anyway, so I agree with Jim to the extent of that, but I think with the rollback of prices, you are going to see more and more rigs stacked up.

Senator JOHNSTON. You know that one point I think a lot of people miss when they look at the statistics—that say 50 percent, almost, of the rigs that are stacked. It is a higher percentage than that, of the deep drilling rigs. The more expensive the rigs, the more that are stacked.

All the Tuscaloosa rigs are stacked in Louisiana now.

Anybody else like to comment on that scenario of supply?

Mr. JONES. We have spent a considerable amount of time looking at the supply issue as a consumer, and of course, from the standpoint of our intrastate operation in Louisiana where the supplies were going to come from, and from our producers' standpoint, we think that there are adequate supplies out there for the near-to-intermediate term that there is a considerable amount of excess producibility. Probably more than shows up in statistics that exist today, and we think that that gas cap or gas bubble is not going to disappear immediately.

It could very well run beyond 1986 in its impact.

Senator JOHNSTON. I don't want to take too much time. I just want to say that I wish you would report to your members and shareholders, that in my opinion this has been one of the most outstanding panels we have ever had.

The CHAIRMAN. Gentlemen, thank you very much for your appearance today. You obviously have pleased one member of the committee extremely well.

I would mention that written statements will be received for the record. Written responses to questions which are submitted to you, we hope we can have them back in about a week or 10 days so they can be made a part of the record when received.

Questions may be submitted by any member of the committee at any time prior to the close of business tomorrow.

We will stand in recess until the hour of 9:30 tomorrow morning in SD-106.

[Whereupon, at 1:57 p.m., the hearing recessed, to reconvene on Friday, March 11, 1983.]

[A statement from Senator Exon submitted for the record follows:]

Statement by

SENATOR J. JAMES EXON

March 10, 1983

Senate Committee on Energy and Natural Resources

RE:

Administration's Natural Gas Decontrol Proposal

Mr. Chairman and Members of the Senate Energy Committee, I appreciate the opportunity to voice my concerns regarding the Administration's proposal to remove all price ceilings on natural gas.

I am not impressed with the President's proposal which, on balance, favors producer interests. Consumer protection offered by the proposal is fleeting and only raises false hopes. The proposal once again confirms the suspicion that the Administration's concept of "free market" means that producers are "free" to do whatever they please.

Price Controls

My first concern is with the Administration's plan to completely lift price ceilings on all "old gas." A recent Library of Congress study conducted at my request has indicated that the top 26 major energy producers control nearly all of this category of natural gas. Even with price controls which hold "old gas" below the average market price for other categories of natural gas, major energy producer gross revenues have doubled since 1978 from sales of natural gas.

In 1978, gross revenues from natural gas for these companies was $9.3 billion. In 1981, this figure rose to $17.8 billion.

With "old gas" selling for around $1.50 per Mcf, removing the price ceiling would raise this price to $3 or $4 per Mcf. Reports in the media have suggested that this could result in a windfall to the major oil companies of nearly $40 billion.

Big Oil would once again be the winner, and America's consumers would once again bear the burden of this windfall.

Those consumers hurt the worst would be those who are serviced by pipeline companies which have large supplies of "old gas" under contract. The Administration's proposal would allow producers to break existing contract with the pipelines and charge the higher price.

Contracts

A few weeks ago, FERC Chairman, Charles Butler, reported that producers have been unwilling to renegotiate contracts with pipeline companies despite changing market conditions. The Administration's proposal only encourages producers to further resist renegotiation efforts. Producers would be more inclined to hold out for decontrol to take effect when higher selling prices would be available and producers could walk away from contract obligations to sell gas to the highest bidding pipeline.

The Congress has sought to encourage pipelines and producers to sit down and renegotiate supply and price terms in existing contracts to more accurately reflect current market conditions. These contracts have placed the industry in a straight-jacket which requires both parties to remove. However, if producers are unwilling to voluntarily renegotiate, and the Administration bill further encourages resistance to voluntary efforts, the Congress can only be forced to act on this matter. It had been hoped that the industry would "keep its own house in order," however, results to date appear to be quite disappointing. Although a handful of pipelines have been successful in negotiating with suppliers, the Administration's proposal certainly will not encourage this process.

Consumer Protections

The Administration's so-called "consumer protection" provisions are temporary and threaten reliable consumer service in many instances.

The proposal would create a new layer of bureaucracy at the FERC, a board which is already dominated by producer-state members, which only serves to delay the pass-through of wellhead price increases charged to pipelines by producers. This delay mechanism is only temporary and would, under the Administration plan, evaporate completely after 1985, leaving absolutely no regulatory review of rates once total price decontrol is implemented.

The proposal throws the entire risk of gas acquisition onto the pipeline. Once again, the producer bears no risk, is insulated from "market signals," and is permitted to extract the highest allowable selling price.

Consumers served by pipelines with large "old gas" supply contracts stand to lose the most under the Administration's plan. As "old gas" supply is depleted and the pipeline's "gas mix" includes more higher cost "new gas," increases in prices for these pipelines would be higher than those pipelines which already utilize higher priced gas in their system. Thus pipelines which have kept cheaper "old gas" in their system would be penalized and may adversely affect service to the customers of these pipelines.

An additional concern about the Administration's "price cap" is that for these same pipelines with "old gas" in their system the "cap" could actually result in higher prices than the Administration contends. Again, as more and more higher cost gas comes into a system which has relied upon cheaper "old gas," average new contract prices or renegotiated prices which would be used as the basis of the Administration's proposed "cap" could actually be higher than current ceiling prices.

Conclusion

I would urge the Committee to carefully consider the implications of the Administration's proposal. It is based upon an unwise premise that low oil prices are here to stay. With world oil prices influenced greatly by the "artificial" pricing system of the OPEC cartel, I would question the wisdom of tying domestic gas prices to OPEC's world oil pricing scheme.

The nation's homeowners cannot benefit from total decontrol. Residential users have no alternative when it comes to heating their homes in the winter. Fuel switching is not a reasonable alternative that is available to homeowners. Agriculture is another captive user. Last year, a Library of Congress study conducted at my request indicated that farm production costs could increase by $2.5 billion under a total decontrol plan.

I would urge the Committee and the Senate to reject the Administration's proposal. Any legislation considered must respect the appropriate balance between protecting consumers from unreasonable and artifical price hikes and the need to encourage production to meet consumer demands.

I thank the Committee for its consideration of my remarks. I would ask that the recent Library of Congress study on "Natural Gas Revenues of Major Energy Companies" be included in the record following my remarks.

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

NATURAL GAS REVENUES OF MAJOR ENERGY COMPANIES
1977-1981

David J. Cantor
Specialist in Industry Economics
Economics Division
March 9, 1983

NATURAL GAS REVENUES OF MAJOR ENERGY COMPANIES
1977-1981

Natural gas sales provide a significant portion of major energy company revenues from their combined sales of domestic natural gas and crude oil. In 1977 and 1978, prior to the world oil price shock of 1979, gas accounted for over 30 percent of their revenues from sales of domestic natural gas and crude oil. In 1980 and 1981, the gas share of these revenues levelled off at about 22 percent. The importance of domestic natural gas to major energy companies is highlighted, also , by the fact that these companies account for approximately half of the volume of natural gas marketed in the United States and of proven natural gas reserves in the country.

This report presents an analysis of the levels and trends of natural gas revenues of 26 major U.S. energy companies for the period 1977 through 1981. 1/ The companies are those whose corporate financial data are reported to the U.S.

1/ The major energy companies are those required to report company financial data to the U.S. Department of Energy, Energy Information Administration (EIA) on Form EIA-28: Financial Reporting System. The companies were chosen by EIA from the top 50 publicly held domestic crude oil producers in 1976, who accounted for at least 1 percent of either production or reserves of oil, coal, or uranium; or one percent of oil production, refining capacity, or petroleum product sales. These companies are: Amerada Hess, American Petrofina, Ashland, Atlantic Richfield, Burlington Northern, Cities Service, Coastal States, Conoco, Exxon, Getty Oil, Gulf Oil, Kerr-McGee, Marathon Oil, Mobil, Occidental, Phillips Petroleum, Shell Oil, Standard Oil of California, Standard Oil of Indiana, Standard Oil of Ohio, Sun Company, Superior, Tenneco, Texaco, Union Oil of California, and Union Pacific.

Source: U.S. Department of Energy. Energy Information Administration, Energy Company Development Patterns in the Post Embargo Era. Volume 1, October 1982, Washington, D.C., p. 99.

Department of Energy, Energy Information Administration for its Financial Reporting System (FRS). The period under review is constrained by the availability of FRS data. Nevertheless, the period extends from the year immediately prior to enactment of the Natural Gas Policy Act of 1978 (NGPA) through most of the period during which NGPA pricing has been in effect, and during the period of sharply rising crude oil prices from 1979 through mid-1981. All of the data discussed herein treat only revenues, production, and reserves for domestic oil and gas operations of the FRS companies.

1. Trends in Natural Gas Revenues of Major U.S. Energy Companies, 1977-1981

Since 1977, the major U.S. energy companies have experienced a more than twofold growth in operating revenues derived from their sales of domestically produced natural gas since 1977. In 1977, the 26 energy companies had gas revenues of about 8.2 billion dollars. Preliminary data for 1981 indicate that their gas revenues had increased to about 17.8 billion dollars, or 2.2 times that of 1977. These data are presented in Table 1.

Over the entire five-year period, combined gas revenues of the 26 companies increased at an average annual rate of 21.5 percent. In general, however, gas revenues grew at an increasing rate over this period: in 1978, the change in gas revenue was 1.1 billion dollars; in 1979, 2.2 billion dollars; in 1980, 2.5 billion dollars; and, in 1981, 3.8 billion dollars.

This acceleration in the growth of gas revenues reflects the phased decontrol of gas prices allowed by NGPA, and the response of producers away from controlled to decontrolled gas sources. From 1978 through 1981, gas revenues from sales of domestic gas by the 26 major companies grew at an annual rate of 24.3 percent.

TABLE I: Revenues from the Sale of Domestic Natural Gas of Major Energy Companies, 1977-1981 a/

Year	Natural Gas Revenues (million dollars)	Year-to-Year Change (million dollars)	Percent Change
1977	8174	--	--
1978	9258	1084	11.7
1979	11491	2233	19.4
1980	13991	2500	21.8
1981 b/	17782	3791	27.1

a/ The major energy companies are those selected for inclusion in the Financial Reporting System (FRS) of the U.S. Department of Energy, Energy Information Administration. The companies are: Amerada Hess, American Petrofina, Ashland Oil, Atlantic Richfield, Burlington Northern, Cities Service, Coastal States, Conoco, Exxon, Getty Oil, Gulf Oil Kerr-McGee, Marathon Oil, Mobil, Occidental, Phillips Petroleum, Shell Oil, Standard Oil of California, Standard Oil of Indiana, Standard Oil of Ohio, Sun Company, Superior, Tenneco, Texaco, Union Oil of California, and Union Pacific.

b/ Preliminary data.

Source: U.S. Department of Energy, Energy Information Administration. Office of Economics and Statistics. By telephone communication, March 3, 1983.

2. Share of Natural Gas Revenues in Combined Revenues from Sale of Domestic Oil and Gas of Major Energy Companies, 1977-1981

Natural gas revenues of the 26 major energy companies were approximately 30 percent of their combined revenues from sales of domestic crude oil and natural gas in 1977-79. In 1980, this share declined to 23.5 percent, and, in 1981, to 22.5 percent. These data are presented in Table 2.

Two factors, in particular, explain this decline in the share of natural gas revenues. First, both domestic and world oil prices rose sharply from 1979 through mid-1981. Second, natural gas price controls prior to NGPA and constraints imposed by NGPA restrained the growth of revenues from gas.

Between 1979 and mid-1981, both world and domestic oil prices rose sharply and persistently. The average refiner acquisition cost of imported crude oil was essentially constant in 1977 and 1978 at approximately $14.55 per barrel. In 1979, prices for imported crude rose more than seven dollars per barrel, and, in 1980, by an additional twelve dollars per barrel. In 1981, the increase in imported crude moderated, and the price rose three dollars per barrel. Over the period, 1978 through 1981, therefore, imported oil prices more than doubled, rising at an annual rate of 36.5 percent from $14.57 to $37.05 per barrel.

Over this period, domestic crude oil prices increased as well despite controls on them through January 1981. In 1977 and 1978 national average domestic wellhead prices were in the range of $8.50 to $9.00 per barrel, but rose to $12.64 in 1979, $21.59 in 1980, and $31.77 in 1981. Thus, domestic crude prices increased nearly fourfold in this period at an annual rate of 53.5 percent. The average value of a barrel of domestic crude oil sold by the 26 major companies was generally lower than the national average domestic wellhead price, rising

TABLE 2: Natural Gas Share of Combined Revenues of Domestic Crude Oil and Natural Gas of Major Energy Companies, 1977-1981 a/

Year	Domestic Natural Gas Revenues million $	%	Domestic Crude Oil Revenues b/ million $	%	Combined Natural Gas and Crude Oil Revenues million $	%
1977	8174	30.8	18374	69.2	26548	100.0
1978	9258	31.6	20057	68.4	29315	100.0
1979	11491	29.7	27219	70.3	38710	100.0
1980	13991	23.5	45547	76.5	59538	100.0
1981 c/	17782	22.5	67216	77.5	84998	100.0

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a/ The major energy companies are those selected for inclusion in the Financial Reporting System (FRS) of the U.S. Department of Energy, Energy Information Administration. The companies are: Amerada Hess, American Petrofina, Ashland Oil, Atlantic Richfield, Burlington Northern, Cities Service, Coastal States, Conoco, Exxon, Getty Oil, Gulf Oil Kerr-McGee, Marathon Oil, Mobil, Occidental, Phillips Petroleum, Shell Oil, Standard Oil of California, Standard Oil of Indiana, Standard Oil of Ohio, Sun Company, Superior, Tenneco, Texaco, Union Oil of California, and Union Pacific.

b/ Preliminary data.

Source: U.S. Department of Energy, Energy Information Administration. Office of Economics and Statistics. By telephone communication, March 3, 1983.

from about $8.30 per barrel in 1977-78 to $29.10 in 1981 at an annual rate of 51.8 percent. These data, published by the Energy Information Administration (EIA) or compiled from EIA data, are presented in Table 3.

These sharp increases in oil prices far exceeded the growth in both national average wellhead prices for natural gas and the average value of natural gas marketed by the 26 major energy companies. The national average wellhead price of gas rose from $0.79 per thousand cubic feet (mcf) in 1977 to $1.98 per mcf in 1981 at an annual rate of 25.8 percent. The average value of natural gas marketed by the 26 companies rose at an annual rate of 25.1 percent from $0.73 per mcf in 1977 to $1.79 per mcf in 1981. These data are also shown in Table 3. That natural gas prices rose more slowly than crude oil prices is a result of the very complex schedule of allowable prices under NGPA, as well as the pricing provisions of long-term contracts entered into by natural gas pipelines to acquire gas.

These trends in prices of both oil and gas explain for the most part why the gas share of total domestic gas and crude oil revenues of the 26 major energy companies fell. Clearly the gas share declined, because domestic oil prices rose twice as fast as natural gas prices. Reinforcing this conclusion is the fact that the volumes of both domestic gas and crude oil were essentially constant throughout the period, with the sole exception of a 15-percent increase in crude oil volume in 1978 (see footnotes to Table 3).

TABLE 3: Value of Domestic Natural Gas and Crude Oil and Imported Crude Oil-National Average and Average Value of Sales of Major Energy Companies, 1977-1981 a/

Year	Domestic Natural Gas Wellhead Price ($/thousand cubic feet)	Average Value of Natural Gas of Major Energy Companies b/ ($/thousand cubic feet)	Imported Crude Oil c/ ($/barrel)	National Average Domestic Crude Oil Price d/ ($/barrel)	Average Value of Crude Oil of Major Energy Companies e/ ($/barrel)
1977	0.79	0.73	14.53	8.57	8.36
1978	0.91	0.85	14.57	9.00	8.27
1979	1.18	1.07	21.67	12.64	11.25
1980	1.59	1.39	33.89	21.59	19.02
1981	1.98	1.79	37.05	31.77	29.10 f/

a/ The major energy companies are those selected for inclusion in the Financial Reporting System (FRS) of the U.S. Department of Energy, Energy Information Administration. The companies are: Amerada Hess, American Petrofina, Ashland Oil, Atlantic Richfield, Burlington Northern, Cities Service, Coastal States, Conoco, Exxon, Getty Oil, Gulf Oil Kerr-McGee, Marathon Oil, Mobil, Occidental, Phillips Petroleum, Shell Oil, Standard Oil of California, Standard Oil of Indiana, Standard Oil of Ohio, Sun Company, Superior, Tenneco, Texaco, Union Oil of California, and Union Pacific.

b/ Computed by dividing total natural gas revenues by total marketed production. The revenue and production data are:

	Revenues	Production
1977	$ 8174 million	11.19 billion cubic feet
1978	9258 million	10.87 billion cubic feet
1979	11491 million	10.71 billion cubic feet
1980	13991 million	10.05 billion cubic feet
1981	17782 million	9.95 billion cubic feet

c/ The values are the Refiner Acquisition Prices.

d/ The values are the domestic crude oil wellhead prices.

TABLE 3: Value of Domestic Natural Gas and Crude Oil and Imported Crude Oil-National Average and Average Value of Sales of Major Energy Companies, 1977-1981 a/ (continued)

e/ Computed by dividing total crude oil (including lease condensate and natural gas liquids) revenues by total marketed production. The revenue and production data are:

	Revenues	Production
1977	$18374 million	2196.7 million barrels
1978	20057 million	2424.7 million barrels
1979	27219 million	2419.3 million barrels
1980	45547 million	2394.5 million barrels
1981	67216 million	2310.2 million barrels

f/ Preliminary data.

Compiled by CRS using as sources: U.S. Department of Energy. Energy Information Administration. Monthly Energy Review, November 1982. U.S. Department of Energy. Energy Information Administration. Office of Economics and Statistics. By telephone communication, March 4, 1983.

3. Additional Observations and Caveats.

The data show clearly that gas is a very significant element of the upstream (or resource extraction) operations of major energy companies, most of which are oil companies. Their gas revenues have risen markedly since 1977. Their gas revenues account for more than a fifth of their combined gross revenues from the sale of domestic crude oil and natural gas; even though this share is down from earlier years, it is still significant.

There are, in addition, other indicators of the importance of natural gas in the operations of these 26 companies. They market about half of the domestic natural gas produced in the United States. Also, they control more than half of the reserves of natural gas in the United States. These data are presented in Table 4.

Three caveats must be stated at this point. First, the data presented in this report refer only to the gross, pre-tax revenues, marketed production, and reserves of domestic gas and oil. International operations are not considered; nor are refining, distribution, or other energy and non-energy business activities of these companies taken into account. In the total picture of the companies' business operations, the revenues derived from production and marketing of natural gas will be a smaller share of total operating revenues.

TABLE 4: Shares of Major Energy Companies of Total Marketed Production and Reserves of Domestic Natural Gas, 1977-1981 a/

Year	Marketed Production: Total U.S. (trillion cubic feet)	Marketed Production: Major Energy Companies (trillion cubic feet)	Share of Major Energy Companies (%)	Reserves b/: Total U.S. (trillion cubic feet)	Reserves b/: Major Energy Companies (trillion cubic feet)	Share of Major Energy Companies (%)
1977	20.03	11.19	55.9	216.0	123.6	57.2
1978	19.97	10.87	54.4	208.9	119.1	57.0
1979	20.47	10.71	52.3	200.3	115.8	57.8
1980	20.38	10.05	49.3	194.9	110.3	56.6
1981	20.37	9.95 c/	48.8	199.0	108.4 c/	54.5

a/ The major energy companies are those selected for inclusion in the Financial Reporting System (FRS) of the U.S. Department of Energy, Energy Information Administration. The companies are: Amerada Hess, American Petrofina, Ashland Oil, Atlantic Richfield, Burlington Northern, Cities Service, Coastal States, Conoco, Exxon, Getty Oil, Gulf Oil Kerr-McGee, Marathon Oil, Mobil, Occidental, Phillips Petroleum, Shell Oil, Standard Oil of California, Standard Oil of Indiana, Standard Oil of Ohio, Sun Company, Superior, Tenneco, Texaco, Union Oil of California, and Union Pacific.

b/ Reserves at beginning of year.

c/ Preliminary data.

Source: American Gas Association. Gas Data Book, 1982. U.S. Department of Energy. Energy Information Administration. Energy Company Development Patterns in the Postembargo Era. Volume 2. U.S. Department of Energy. Energy Information Administration. Office of Economics and Statistics. By telephone communication, March 3-4, 1983.

Second, no inference regarding the contribution of gas to the profitability of the 26 companies can be made. The revenue data do not net out costs of production or other expenses related to this segment of company business, largely because natural gas operations cannot be conveniently separated from oil operations. For this reason, companies do not report separate cost data for oil and for gas. Nor are there accepted accounting practices and standards to achieve this separation.

Third, the data are not sufficiently disaggregated to identify the natural gas marketed, or reserves, by NGPA category. Even though the average value of gas marketed by the 26 companies is below the national average wellhead price by approximately 10 percent, this difference points only to the possibility that older, price-controlled gas is held, produced, and marketed to a greater extent by the 26 companies than for all gas producers. Data on the volume of natural gas broken out by NGPA category are not available either for all 26 companies together or for individual companies to permit any firm conclusions to be drawn on this subject.

NATURAL GAS LEGISLATION

FRIDAY, MARCH 11, 1983

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m., in room SD-106, Dirksen Office Building, Hon. James A. McClure (chairman) presiding.

Present: Senators McClure, Weicker, Wallop, Warner, Murkowski, Nickles, Hecht, Heinz, Johnston, Jackson, Bumpers, Ford, Metzenbaum, Melcher, and Bradley.

Also present: Charles A. Trabandt, chief counsel; E. David Doane, deputy chief counsel for energy; Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. JAMES A. McCLURE, A U.S. SENATOR FROM THE STATE OF IDAHO

The CHAIRMAN. The committee will come to order. Today's hearing is the third day of the committee's hearings on pending natural gas legislation. The testimony to be received today will be primarily from organizations representing all three components of the natural gas industry: the producers, the pipelines, and the distribution companies.

During the past 2 days of hearings, the committee has received widely divergent estimates of what would occur if the administration's bill were enacted.

The Department of Energy has calculated that the bill would reduce average gas prices by as much as 30 cents per thousand cubic feet in the first year after enactment. That would result in a savings for consumers of about $6 billion in 1 year.

However, we were told yesterday by several consumer groups that the administration's bill, by decontrolling old gas, would increase gas prices by $40 to $50 billion.

Here in the Congress we are accustomed to dealing with differences of opinion. Sometimes we merely acknowledge a disagreement and then work around it.

However, in this instance, on the critical issue of the price impact of the administration's bill, this committee is obligated to make its own best judgment of what the impact will be.

I note that the predictions we have heard so far come from those who merely observe the gas industry. They study it and comment on it but they don't operate it. Today the industry has the opportunity to speak for itself. I invite each witness to comment specifically on the predictions I have mentioned. I would like to know, and I am sure my colleagues would too, your assessment of what would happen to gas prices if the administration's bill were enacted.

But before we hear from the first panel, let me call on Senator Metzenbaum for any statement that he would like to make at this time.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. Mr. Chairman, it is a fact that there have been different estimates of what the cost of the administration's bill would be. The administration claims that there would be some saving. I, myself, have the feeling that, in the Senate, when you are in doubt, you ought to vote "no." I think it is a pretty fair policy to follow, generally speaking.

The up side, if the administration happens to be right, would be very little. But if the administration happens to be wrong, the down side would have an impact upon this Nation's economy that is probably unprecedented. It would cause a massive movement of wealth from the consumers of this country to the major oil companies of this country and to other gas producers.

Today we are going to hear from those who are at the downstream end of the gas pipeline system, distributing the gas to the customers. According to my information they will indicate their opposition to this bill. I think that their opposition is particularly significant.

I know that I have been in many disputes in my own State with the public utility companies of that State concerning the question of natural gas prices. In this instance, I am pleased to note that they will be here testifying against this bill because they recognize the horrendous impact it would have upon their customers and the economy.

In my opening statement to this committee I said that I was quoting Mr. Jack Tankersly, who was once president of the East Ohio Gas Co. I meant to be quoting Dudley Taw for the estimate that the cost would be $60 billion if there were total decontrol.

Regardless of whether it is 60 or 40 or 180, whatever, the fact is the impact would be horrendous. I think that the sooner we bring this bill to its early demise the better. We will have served the people of this country and will have made it more possible for the economy, if it is in an upturn at this moment, to roll on in that upturn. If it isn't in an upturn we will at least keep it from sinking any further.

The CHAIRMAN. Senator Ford?

Senator FORD. I thank the Chairman. I just look forward to hearing the witnesses.

The CHAIRMAN. Senator Hecht?

[No response.]

The CHAIRMAN. Before we turn to the first panel, Senator Specter was scheduled to appear yesterday, but it was impossible for him to be here at the precise time that was scheduled, so we are pleased to accommodate him first thing this morning. We are happy to have you here.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Mr. Chairman, thank you very much. I commend the chairman and the committee on having these very extensive hearings. I understand you are proceeding for hearings again tomorrow morning. You may, on an unusual arrangement, be in competition with the Senate itself.

The CHAIRMAN. We didn't expect to be.

Senator SPECTER. There are a good many changes in the course so you may have competition. But I appreciate your accommodating my schedule, Mr. Chairman. I had been scheduled on Wednesday and then on Thursday I was inflicted with the Appropriations Subcommittee on Commerce so I could not be here and I am grateful for this opportunity to appear and testify.

I have submitted the statement and I shall summarize very briefly because I know you have many witnesses to hear.

The CHAIRMAN. The statement will appear in the record in full. Thank you.

Senator SPECTER. Thank you, Mr. Chairman I have been studying the gas issue for some time, not only because of the extensive concerns of my constituents in Pennsylvania but also in my capacity as cochairman of the Northeast-Midwest coalition and, on behalf of that coalition, then produced legislation last December. The chairman scheduled hearings of this committee at that time on the problem as it was coming to a crescendo point at the end of 1982.

The studies which I have made and the citizen's group that I have talked to and the industry representatives whom I have talked to lead me essentially to two conclusions, Mr. Chairman. I think one is agreed to virtually by everyone and that is that the pricing of gas is an absolute mess as it now exists, with fantastic variations and with "take or pay" contracts and enormously high prices in some quarters and great divergence and a formula which just defies understanding.

A second conclusion, which I think is emerging, on which these hearings will shed great light, is the issue of increase in cost. I have noted, and my statement contains the information gathered by staff, that the Citizens/Labor Energy Coalition estimates that decontrol of old gas will cost in the neighborhood of $60 billion a year.

Mr. George Lawrence, president of the American Gas Association, which supports the administration's proposal, has said that the acceleration of old gas decontrol will create upward price pressure.

As the picture is emerging on decontrol increasing the cost of natural gas, it is my thinking that it is going to be a political impossibility to pass legislation which has decontrol with the probabilities present on an upward increase in cost. That comes through to me, as I hear the witnesses and see the reports of the media on both sides of the aisle, and many of the colleagues of you and me, Mr. Chairman, Senator Hecht on the Republican side of the aisle, and as I count the numbers at the present time, as the picture is emerging, that the bill, the administration's bill will increase the cost of natural gas, I think it may be that Senator Metzenbaum will be denied an opportunity for a filabuster.

Senator Metzenbaum may call for an early vote, as the picture may be emerging that there is going to be an increase in the cost as a result of the administration's bill.

I am prepared to listen and I am prepared to see the final outcome of the hearings and to see what this committee concludes and what the facts are.

As I have traveled through my State I have heard more complaints about natural gas than any other single item with the possible exception of the overall economy and the unemployment picture.

I have traveled the length and breadth of it and I think that is the great advantage and that is the great addition that those of us in the Congress can bring to these hearings, because we do have the responsibility to go out and meet people. If we are serious about our jobs and about our interest in staying here, that is a uniform reaction which all of us have. There have been more cancellations in the Senate today on Friday afternoon plans and Saturday travel plans of constituent plans, so if you tabulated the number of cancellations of speeches by the 100 Senators, it is probably in the range of 200, 300, or 400. There are a lot of people out there who aren't going to be addressed tonight and tomorrow because of the Senate being in session.

But as I traveled illustratively in Pottsville, Pa., a very prosperous company had to close its doors last fall when the increases came into effect in Pennsylvania on September 1, 1982, increasing the cost of natural gas by 38 percent.

Last Saturday I was in Midland, Pa., which is the home of Crucible Steel, where the single employer virtually in the town laid off 4,500 people in June 1982. The steel industry takes second place to no one in terms of economic problems.

But the first issue raised by 600 people who crowded into a high school auditorium was the issue of natural gas. Senator Heinz and I went there to meet with that group and that was their first concern.

When I look at the statistics about people who are on the maximum of supplemental security, and after they pay their gas bill they have $75 left for rent, food and all the other expenses which they have, it is really an issue of eat or heat. I think that it is just mandatory that whatever emerges from this committee from the Congress that there be guarantees and I understand the difficulty of using the word "guarantees" because that is a very strong term. But I think that is what we have to have, guarantees that the cost of natural gas will not go up, that whatever action is taken, decontrol has that possibility. Then it is simply not politically possible or possible in humane terms to have that kind of a conclusion come forward from the Senate, from the Congress.

In the text of my testimony, Mr. Chairman, I have discussed the problems of "take or pay" and it seems to me that those contracts have produced a very unfair consequence, some requiring an excess of 85 percent and a pricing policy which is just absolutely horrendous.

I know you have heard extensive testimony on that and I know that will be a highlight of consideration by this committee.

The problems of the indefinite price escalators are also dealt with in the course of my testimony and I think they ought to be abolished. They don't have any real market purpose and they are not designed to really protect the interest on a cost-of-production factor for those who have produced gas. I would say that I am concerned about those producers who have, in reliance upon the 1978 act, gone out and engaged in very extensive, expensive production for natural gas. To the extent that there is action taken by the Congress which abrogates existing contracts, it is my sense that there ought to be exceptions provided for those who, in reliance on what Congress did in 1978 and spent expensive sums of money, so that if they can show that kind of hardship they ought to be excepted from any provisions which would abrogate the contracts on which they have come to rely.

Mr. Chairman, that is the instance of my presentation. I am delighted to see these problems in the capable hands of this committee and I am prepared to work with you and study this problem, and we will study your report very, very carefully.

But I do want to emphasize as strongly as I can the imperative nature of our work in the Congress making the guarantees that the current critical situation will not be aggravated by any action which we take on decontrol or otherwise.

[The prepared statement of Senator Specter follows:]

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Mr. Chairman, I would like to commend Chairman McClure and the Committee on Energy and Natural Resources for conducting these hearings into one of the most critical issues before the Congress on the deregulatin of natural gas. There is widespread agreement that modifications are needed in the regulation of the natural gas market. There is less agreement on how to accomplish this. These proceedings will help Congress achieve the common goal of ensuring sufficient supplies of natural gas at costs that are just and reasonable.

I previoulsy expressed my concern for escalating natural gas prices in December when as Co-chairman of the Northeast-Midwest Coalition, I introducted The Temporary Natural Gas Market Correction Act of 1982. That bill proposed to temporarily eliminate take or pay provisions in contracts between producers and piplelines and required that pipelines purchase the cheapest available gas. I sponsored that measure because I believed that immediate action had to be initiated to address the urgent problem of natural gas pricing. I still feel the same today.

I would also like to thank the Chairman for providing me this opportunity to testify on the Natural Gas Consumer Regulatory Reform Amendments of 1983, introduced by Senator McClure at the request of the Department of Energy.

My sense is that changes to the Natural Gas Policy Act of 1978 (NGPA) are clearly necessary, but not at the expense of the consumer. In formulating legislation, I am hopeful that the Senate will take the following considerations into account.

First, in contracts between gas producers and pipelines, certain provisions have proven to be impurdent business practices. These clauses, entered into at a time of severe natural gas shortages, have caused a substantial increase in the cost of natural gas for the consumer. Known as "take or pay" provisions, they require that a pipeline either take the gas contracted for or pay for it anyway, regardless of the ability of the pipeline to market the gas. This results in the pipeline passing on the additional cost of unsused gas to the consumer. Many contracts have take or pay provisions in excess of 85 percent. This situation needs to be corrected. The Committee should remain receptive to suggestions to lower this percentage when evidence offered at these hearings indicates that reductions would still enable pipelines to supply gas at lower rates without unduly injuring the interests of the producer.

Further hearings need to be held on this specific aspect of the natural gas problem. At this point in time, our knowledge is not sophisticated enough to set a proper maximum take or pay percentage level for contracts between gas producers and pipelines. The Northeast-Midwest Coalition bill I introduced last year temporarily eliminated all take or pay provisions. This action was necessary to respond to the immediate crisis facing that region. However, now that Congress is readdressing the entire natural gas issue, there is time to give attention to take or pay provisions. Hearings will permit all sides to present their arguments and support them with facts. Producers of natural gas must be afforded the opportunity to demonstrate the need for retaining take or pay contracts. Consumers too should be heard and their views taken into consideration.

Second, regulatory controls should be retained over some categories of gas.

Under S. 615, all controls on "old gas"—gas drilled from wells existing before 1977—will be lifted by January 1, 1986. This gas was explored for, drilled and sold at a price which provided companies with sufficient profits at that time. Under the NGPA, the Federal Government maintained regulations on old gas to protect consumers from paying high prices for gas already on hand and available. Removing this protection would eliminate the NGPA's most important consumer price protection.

Although the target date for old gas decontrol under S. 615 is January 1, 1986, most old gas may already be decontrolled as the bill grants the parties the authority to renegotiate existing contracts. Contracts that have been renegotiated will operate according to its new terms. The bill makes the assumption that rates will decline because pipelines and producers will probably renegotiate new contracts at lower prices. This assumption, however, may prove to be wrong as there is no mechanism to preclude the reverse from occurring. Therefore, this provision could amount to an escape clause for producers that enables them to ignore present price ceilings.

It is estimated by the Citizen/Labor Energy Coalition and others that the decontrol of old gas may cost consumers as much as $60 billion over the next few years. Currently, old gas supplies more than 50 percent of Pennsylvania's natural gas needs. Any significant price escalation in this category of gas will cause severe economic hardship for residential and industrial users in my state.

Consumer groups are not the only ones who believe prices will rise. According to George Lawrence—president of the American Gas Association, which supports the new proposal—the acceleration of old gas decontrol will create upward price pressure.

Additionally, by deregulating old gas, incentives for drilling new gas will be reduced. In 1978, Congress responded to the acute shortage of natural gas by deregulating deep-drilled and difficult-to-recover gas. These provisions allowed producers to drill for expensive gas and still realize a profit. If windfall profits can be made selling old gas that is decontrolled, the incentives for costly exploration in the short-term will be removed. This may cause shortages in the long-term, threatening a continuation of current price uncertainty.

The third factor I think essential for Congress to consider before it passes legislation on the natural gas area concerns indefinite price escalators. These are common provisions in contracts between producers and pipelines. One type of escalator requires that the parties renegotiate the wellhead prices of gas upon deregulation. This may cause rates for gas to skyrocket when deregulation takes effect. Another form of indefinite price escalator clause requires the pipeline to pay for gas at a level equal to the highest price paid in the same producing area. This second form is also referred to as most favored nation clauses. The proposal in S. 615 to limit these price escalators by imposing a cap that is equal to the volume-weighted average for the price of natural gas in all contracts, does not achieve the desired results. Since all new contracts are deregulated and all old contracts may be deregulated through renegotiation, the weighted average of old and new gas provides little protection to the consumer.

The elimination of price escalator clauses, I believe, would not substantially harm the gas producing industry since they are not tied to costs of production. However, such action would insure that the consumer not be liable for dramatic and often unjustifiable gas rate increases.

Generally, natural gas pricing under the NGPA has not functioned well. Currently, demand for natural gas by end users is declining, while gas prices have only responded slightly to the decreased demand. By the Federal Energy Regulatory Commission's [FERC] own analysis, the pricing provisions of conventional gas purchase contracts do not permit downward pricing flexibility; market forces have not restrained producers from receiving the full ceiling prices established for high-cost gas and from receiving even higher prices for deregulated gas.

Further proof that pricing under NGPA is excessive, is that the delivered price for gas in many areas exceeds that of competing fuels. Distributors of natural gas and pipelines have lost many of those industrial customers who can readily switch to cheaper alternatives, such as No. 6 fuel oil. Since fixed transmission and distribution costs are spread among fewer customers, the loss of industrial users results in higher prices to residential users and other customers who cannot immediately switch to other, cheaper energy sources.

The hardships caused by the recent harsh price increases have been frequently communicated to me during my numerous visits to Pennsylvania and through the thousands of letters that I have received on this matter. From 1978 to 1981, the average annual statewide residential gas bill rose from $264 to $600, an increase of 127 percent. This figure compares with an average rise in income for Pennsylvania of only about 30 percent over the past four years. Approximately half of the state's 4.2 million residences rely upon natural gas for their home energy needs.

In addition, certain individuals are particularly hard hit by price increases. The Citizens Labor Energy Coalition estimates that elderly individuals throughout the country who receive the maximum Supplemental Security Income benefits will have less than $75 left each week this winter to spend for housing, food and all of their other expenses after paying their gas bills.

Utility bills for natural gas users during the winter of 1983 have increased more than 25 percent over last winter's costs, forcing many industries in the Northeast and Midwest to shut down. These plant closings have resulted in the loss of an estimated 300,000 jobs. This already recession-worn region could ill afford to lose these jobs and businesses.

For the economic well-being of my state and the nation, order must brought to the natural gas market. For the health and safety of the citizens of my state and the nation, natural gas must be provided to consumers at a reasonable rate. Paramount among the challenges facing the 98th Congress is the task of correcting the present irrational natural gas market. I am hopeful that incorporating the recommendations I suggest today will guarantee an adequate supply of natural gas at a reasonable cost.

The CHAIRMAN. Senator Specter, thank you very much for a thoughtful statement. It again underscores what those of us who work with you know is true, and that is that you do your homework, you are concerned about what happens to people you represent, and that you do articulate their concerns here.

There is only one comment I might make and one concern that I have in a very, very complex subject and in a very, very complex area of the economy. We tend to oversimplify in order to improve our communication. We try to make the statement as bare and simple as possible so people will understand what we say.

I am a little concerned about the public misunderstanding what we can or cannot do sometimes growing out of that attempt to communicate.

You warned—and I think perhaps it was an adequate and a fair warning—that unless we can guarantee to people that their prices will not go up, it is going to be politically difficult or perhaps impossible to pass this legislation, and I think you would know that we can't make that guarantee, that it is impossible to guarantee that prices will not rise except in one regard: We could guarantee to them that the current supplies of natural gas are available to them at no increase in cost until they run out. We can make no other guarantee about price not rising. I think you would agree with that because every unit of energy that is consumed will be replaced by another that costs more. Ultimately, inevitably, at some point price will rise. Now, we could take the existing supplies, put an absolute ceiling on price, make the producers absorb all the increased cost of distribution and guarantee there will be no price increase, and we can make that stick until the existing supply runs out, and when that supply runs out, that is the end of that.

But I think you would agree that that is the only way we could guarantee that price will not rise, would you not?

Senator SPECTER. That may well be true, Mr. Chairman. The blic perception of decontrol is more than suspicious; it is aggraated. There may be another way of providing the guarantee beyond what you have suggested. That would be a combination of low-income energy assistance which——

The CHAIRMAN. We could subsidize——

Senator SPECTER [continuing]. Which could be a part of this legislation which could be tied into it directly. That would be another way of providing a guarantee for a certain element of the community.

But when you talk about communications, I agree with you totally. I start off on the issue of the public perception because we do not really know what is going to happen as a consequence of most of what we do. In the economic field it is just impossible to make predictions. You have three economists who appear before this committee and you get four opinions.

The CHAIRMAN. Six. [Laughter.]

Senator SPECTER. I have sat with the experts on natural gas and have tried to figure out the flow and tried to figure out the predictions and it is impossible to do. But the political reality is that, coming from a State like mine, where there are 1.8 million households which are heated by natural gas and 50 percent of the businesses are heated by natural gas, it is not possible to ask that constituency to take any risk. That is the problem.

The CHAIRMAN. That raises another problem and that is the people who would like to guarantee people a risk-free society. Unfortunately, that too in my judgment is impossible. There is a risk in being born and there is a risk every day of our lives.

Senator FORD. Mr. Chairman, I understand this country has the right to go broke.

The CHAIRMAN. We seem to be exercising that right. [Laughter.]

I understand what you are saying and I think you articulate very well the concerns that people have. I don't mean to in any way detract one word from what you have said. But I think it is worth noting too that that company that closed last year closed because of price structures built into existing statute. That company would have closed without us even discussing whether or not we are going to legislate further. I would suggest that we can confidently predict that there will be further price rises under the existing law.

Unless we legislate, there is a predictable course that will be followed, perhaps more predictable than saying we will open it up to a greater market force, but at least it is a predictable rise in price.

I think that people who are concerned about the impact upon consumers must also look at what will happen to the consumers of this country under the existing statute. That is why we are having these hearings, to see what we can do to depart from the status quo in a way that might be more beneficial than the status quo.

Senator SPECTER. Well, Mr. Chairman, I infer from your comments that I have not provided the answer.

The CHAIRMAN. I have been listening carefully. [Laughter.]

Senator Specter. And my inference, from your comments that I have not arrived at the answer to these complex issues, is not a surprise to me. [Laughter.]

The Chairman. And I am not saying that at the beginning of these hearings I have the answers either. That is why we are having the hearings.

Senator Specter. I come to you giving you the perspectives that I have seen. You and I have talked about a great many subjects over the course of the past 2 years plus and there are a great many dimensions to it.

The feel of the people and the difference between the perception and the reality is something that has to be taken into close account by all of us who have to make the decisions. That is an impact that I do want to bring.

You have got enough meetings to cover in Idaho; you can't cover the ones in Pennsylvania too. So to the extent that I can give you that feel, I think that is a helpful ingredient in your admixture because you have to make the next line of judgment here.

The Chairman. Well, I do agree certainly that the reaction of the people out in Pennsylvania and Idaho and the other 48 States is a very real part of what will go into the consideration and the ultimate solution, if indeed there is an ultimate solution. There'll be one whether we do something or not.

Thank you very much for your testimony.

Senator Ford, do you have a question?

Senator Ford. Senator Specter, let me just delve into one thing that seems to be popping up in the thread that goes through the testimony to date. You come to the Senate with an extremely fine reputation of having a legal mind. If you had been representing a gas pipeline or a natural gas distribution system in the conditions of 1977-79, what kind of contract would you have recommended to your client in that era?

Senator Specter. I do not have a comprehensive answer for you, Senator Ford. I would have sought to have maintained really more flexibility even at the expense of not encouraging production. Now, that may be 20-20 hindsight.

But the difficulties have arisen as of 1983 with being tied in at very high prices. So there was an overcommitment on price in the quest to have the new production.

I would have looked for more flexibilty and perhaps standards which would have permitted downward adjustments, depending upon market forces. If you could have predicted what the market forces would have been, perhaps the purchasers could have factored in the circumstances which would have enabled some modification, producers would have been willing to take some risk on their side of the contract.

Senator Ford. Senator, at that time we were not worried about unemployment because of the economic condition of the country; we were corcerned about—and Senator Metzenbaum has gone—over 200,000 employees of Ohio who were out of work because they had a natural gas shortage. So we were attempting to encourage new exploration at that time and at the same time not let the prices accelerate. We were moving some natural gas from intrastate into interstate pipelines. Contracts for that production, which was in a shortage, put the principals in somewhat of a bind in order to secure adequate natural gas to serve the customers with whom they had a contract.

I find us today now saying those contracts are bad and that is part of the problem and the "take and pay" and, you know, we get into that and that may be true.

But I look at—I am not a lawyer. My dad said a little knowledge of the law is dangerous; get you a good lawyer and stay with him. I am going to try to stay with you if I can here.

How do you go about this august body saying to you your contract is no good, we are going to cancel it, abrogate it or whatever those big words are from that sphere of our English language?

How do we just decide a contract is void, you have to reduce it? Do the times dictate anything different? Something about that bothers me. I am trying—let me just give you an analogy.

I am trying hard to see that unemployed railroad workers get 10 weeks. Everybody else has gotten about 55 weeks. The philosophy is that they made a deal back there, let them sink or swim in it. Well, they are just as unemployed as anybody else. They have all kinds of problems. I want to help. But that was a contract for those railroad workers and to heck with them.

Now, are we going to take that attitude here in natural gas as it relates to contracts, the financial institutions that have guaranteed and have loaned money, that sort of thing, based on that contract?

I have a real problem and it bothers me and I have expressed this privately and now I am going to express it publicly.

Do you have any recommendations as to how we say to those two individuals or three—the producer, the pipeline, the distribution system and the banker—I guess you would say four—that we are going to make you sit down and renegotiate that contract?

Senator **Specter**. Senator Ford, there are ways legitimately, under the law, considerations of public policy, to abrogate or alter or nullify contracts. But that is a part of our legal system.

The National Football League enters into an arrangement where a team cannot move from one city to another absent certain agreements. Then the antitrust laws of the United States come into play and say that private contracts are void under certain circumstances if a judge in Los Angeles says the Raiders move from Oakland to Los Angeles. So there is a contract which has been nullified by a public policy as determined by the Congress.

There are cases where mortgage foreclosures were prevented in the Depression on grounds of paramount public policy. There are policies which have to be pursued and private contracts will be terminated.

There is a contract clause in the Constitution which for years was viewed as not permitting legislation to alter private contracts. That has been bent and broken in some situations when there was a determination made that the interests of public policy are paramount over private contractual rights.

The situation is so bad, from a national welfare—and just as a legal proposition, that we will place that public policy above the private contracts.

In my earlier comments I said that if you come to the take-or-pay contracts and you have producers who have relied upon the

1978 legislation and they would suffer hardship that there ought to be exceptions made terminating, abrogating, or canceling their contract where that can be shown.

But where you have a nation caught in the grips of pricing of natural gas which inflicts great pain and suffering and distress, then private contracts may have to take second place. The law does accommodate for that. There are precedents for it. I think there is a sound, public policy basis. But private contracts should not be interfered with except in the most serious public policy considerations and then there ought to be exceptions where there is hardship on those who have contracted.

Senator **Ford**. What you are saying to me then is that we are going to have a very difficult time drafting legislation to weave a thread through those that have been working hard to keep the price low. That we are going to have to be very sensitive to the way we craft this legislation in order not to hurt those that have done a good job and to help those that are in trouble.

Senator **Specter**. Precisely. It is a difficult matter and a good bit of it may depend upon the financial circumstances of that producer who went in for deep gas and who relied upon what Congress said in 1978. The legislation we craft may have to vest substantial discretion on the Federal Energy Regulatory Commission to deal with these matters on a case-by-case basis. That is what the law does.

But all across this country today there are contracts which are being abrogated. There are mortgage foreclosures in Pittsburgh, Pa., which have been held up by the courts although there is no legal basis for doing so on the technical words of the law. Discretion is being exercised by judges not to force people from their homes. And contracts and the sanctity of contracts are a very high value in a free society enabling businessmen to make calculations and to function. But there does come a point where the Congress may have to take some action to modify them.

Even what we do is very much subject to the considerations of due process of law. We do not have unbounded discretion. We have to function within a constitutional context and what we do may be unconstitutional so the powers of the Congress are very definitely limited.

Senator **Ford**. Let me ask you this. The administration's bill, which we will use probably as markup and on which we are holding these hearings today, let anyone break a contract and there are no grounds in the bill that, as I understand it from advice from counsel, are necessary. Is that a constitutional position in your opinion or is that constitutional in your opinion?

Senator **Specter**. It may well depend upon the circumstances of application. There are provisions for renegotiations which are not too clear in my mind as to whether that requires a mutuality of consent on what we call a novation in the law to have a new contract, or if one party can simply say, "I am not going to abide by it any more."

But the Congress may be acting. It depends upon how strong the public policy is and how great the need is and the circumstances of the individual cases as to whether that would be constitutional.

Senator **Ford**. Well, Mr. Chairman, my 10 minutes are up. I thank you for the opportunity and I thank Senator Specter. But if we are going to get into the posture of weighing every contract case by case, I don't care whether you pass this bill or what you do. With that in there it will be years down the pike before we will have any contracts approved case by case, or you have an escrow account that will be so large the Federal Government could probably borrow from it.

The law will expire by the time we get all the contracts agreed to.

Senator **Specter**. Well, there is no question, Senator Ford, that whatever we do will be extensively considered across the street in the Supreme Court and in the courts of this land.

A good bit of the application of the law has to depend upon the discretion of an administrative agency somewhere down the line, or the administrative law judge, to apply the broad principles that the Congress will establish.

The **Chairman**. Thank you, Senator.

Senator Heinz.

Senator **Heinz**. Thank you, Mr. Chairman.

I just want to welcome my colleague and friend from Pennsylvania back from the wars. Not only from our town meeting up in Pittsburgh in Midland, but the squash court when he was brutally attacked at 7 a.m. by a fellow member of the Senate quite accidentally.

Senator **Specter**. It may not be believed, Senator Heinz, but Senator Packwood and I were not discussing natural gas pricing when he struck me.

Senator **Ford**. You should have voted for him for chairman. [Laughter.]

Senator **Heinz**. That was a secret ballot.

Senator **Specter**. I did, and he knew it.

Senator **Heinz**. Senator Ford, I want you to know that although Senator Specter only had a small reminder, that Senator Packwood's racquet is in smithereens.

Senator **Ford**. It shows a hard head, maybe.

Senator **Heinz**. We Republicans are pretty tough, actually.

I want to compliment Senator Specter on his very good case for the need for an effective remedy for what is clearly a distortion of the market. It is ridiculous that prices of natural gas should be so far in our consuming States in particular, but in many other States as well, above the so-called market clearing price.

There are going to be a number of approaches, you mentioned some of them, others have mentioned some of them, to deal with this. For my part, I can identify just within four decisions or four practices some $25 billion worth of savings, which my legislation, and perhaps others would address.

For example, it is well known that when FERC changed to a dry Btu measurement to wet, as my bill would do from when it was wet to dry as the FERC changed it, that would save $2 billion.

The interpretation of area rate clause orders, the 23 series, is costing $12 billion. If my legislation were enacted, we would actually save consumers $12 billion there. And orders implementing the NGPA section 110 production related costs, that is another $10 billion cost.

If we just did those modest things, just those three things, we could save consumers between $20 and $25 billion this year. Certainly, there are other things worth considering.

My question, I guess, is would that be enough price relief. That would amount to about $200 per household in price relief.

Do you think that that would be from the standpoint of the Northeast and the Midwest a sufficient undertaking?

Senator SPECTER. Senator Heinz, that might well be enough. It would certainly be a big start, and in the right direction. Those ideas which you have advanced are excellent ideas, and would go a substantial distance.

Before you arrived, I had commented to the committee about the meeting which you and I attended in Midland last week on the crucible closing. And the hundreds of people who poured into the high school gymnasium.

As bad off as steel is, and as many problems as they have, they put at the top of the list of the questions which they asked you and me natural gas.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, very much, Senator Specter. I appreciate your testimony today, and your responses in the discussion that has taken place since you made your statement. Thank you, very much.

Senator SPECTER. Thank you.

The CHAIRMAN. We will next hear from the Honorable Robert D. Orr, Governor of Indiana, representing the National Governors Association.

Governor, you are very welcome before this committee. It is always a pleasure to greet you here.

STATEMENT OF HON. ROBERT D. ORR, GOVERNOR OF INDIANA, ON BEHALF OF THE NATIONAL GOVERNORS' ASSOCIATION

Governor ORR. Thank you, very much, Senator McClure, and members of the panel. I am hear speaking both for the State of Indiana as well as for the National Governors Association. I have testimony covering that of the National Governors Association, which I will submit in full for the record.

I have a statement which partially covers that, which I will attempt to read in brief. But it is important, I think, that I make the point that to some very large degree, the State of Indiana is in comparable difficulties to that of the State of Pennsylvania.

Indeed just yesterday, I had a significant conversation with members of the steel industry. And the same kind of testimony that I heard from Senator Specter came out in that discussion as well. It is a serious matter.

The CHAIRMAN. Your prepared statement will be placed in the record in full, and you are invited to summarize it in whatever manner you desire.

Governor ORR. Thank you, Mr. Chairman;

Let me indicate that as the Governor of the State of Indiana, my name is Robert Orr, and I am appreciative of the opportunity to represent 5.5 million citizens of Indiana as well as the other Governors.

By tradition, Indiana does not often come to Washington with its hand out.

As a matter of fact, we are known as a major donor State, and we, generally speaking, are either at the very bottom of that listing, or at the top, depending upon how you view it. We believe in taking care of ourselves.

But let me make this point: That during the past 2 years, these have not been ordinary times for our people.

On any given week during 1982, as many as 800,000 Hoosiers have been out of work, and our unemployment rate has consistently been three or four points above that of the national rate. It is, at the present time, at 13 percent.

In some of our communities, for every 80 people working, there are 20 without jobs. The State Government has had to balance steadily declining income with ever-increasing calls for help.

And the tenacious recession continues to grip Indiana, and any loosening is expected to be slow, and a very deliberate process.

Added to the menace of recession in recent months has come another peril which has so frustrated Hoosiers, so rankled us, so evoked our anger, that I am here today to relay the message, loud and clear, of what is strong language—we are mad as hell; and we cannot take it any longer.

The source of our wrath is the rapid escalation of natural gas prices.

In the last 12 months, the average citizen of Indiana has seen his gas bills increased by 40 to 50 percent, due, primarily, to pricing practices allowed under the Natural Gas Policy Act of 1978, and followed by the Federal Energy Regulatory Commission action.

Recent increases resulting from the latest round of supplier gas purchases have added somewhere from 24 to 56 percent more onto the customer's bill, depending upon the particular gas pipeline and gas distributing company.

The strain of high gas bills weighs heavily on every Hoosier, from our elderly on fixed incomes to our unemployed who certainly have had repeated blows and they are now getting it again with the heating bill—to the backbone of our Hoosier populace, the middle income family, who, 1 year ago, were able to sock away a little extra toward their children's college education, but today shake their heads in bewilderment because all of the extra has been swallowed up by increasing utility rates, primarily gas.

Never have I, as a public official over a good many years, received so much mail on a single situation. Most of my correspondence expresses confusion and disbelief that in a free market society such as ours, the laws of supply and demand are not working.

Some Hoosiers contact me out of sheer desperation—such as a woman from southern Indiana, who writes, and I quote her letter:

"We are of modest means, but the 40-percent increase in the gas bill can come only out of the meager amount we have set aside for food each week."

That is something which has been repeated and repeated, and Senator Specter repeated it before you: It is either heat or eat.

Individuals are not the only ones affected by exorbitant gas bills. Business, especially small business, has also been hurt by skyrocketing gas costs.

Many businesses are caught between the rock and the hard place, trying to decide whether to pay the gas bill or call workers back from furlough.

In this instance, when the gas company wins, our economy loses.

Economic recovery in Indiana—and nationwide—can only be hampered by the continuance of gas price increase after increase. Remember, homeowners can look forward to some relief as the spring and summer months come upon us. But, for the business which uses natural gas in processing, there is no impending relief. Those costs will go up and up, under present circumstances.

One employer in Indianapolis tells me that his gas bill for December of 1982 reflected a 53 percent increase over his bill of the year before, and he has been using less gas.

He views this large increase in a 1-year period as totally unreasonable, unfair, and unjustifiable. It represents, he writes, an incredible breach of the public trust. Schools, government, hospitals—public facilities, in other words—are often overlooked. They are caught in the same gas squeeze, and add to the taxpayer's burden.

Back in the winters of 1976 and 1977, some Indiana schools did close their doors temporarily because of gas shortages.

Today, the doors are being closed on the development of some new programs in our schools because the necessary funds are being diverted to pay higher utility bills.

The one common thread weaving throughout my correspondence and conversations with Hoosiers is that they are frustrated, confused, and in great need of relief.

Unlike Senators, Governors are in their home States, and meeting after meeting to which I go, people come up to me, day by day by day.

Fortunately, for those in the most desperate straits, our emergency assistance program, which we call Project SAFE, has been able to alleviate the problems for some of these bills.

And thus far, we have helped 170,000 households, and have obligated some $37 million for that purpose.

For many Hoosiers, there seems to be a high degree of confusion about just who, in government, is the appropriate source of relief.

They very often point their finger to our State Public Service Commission and say: "Do something."

To a very limited extent, the public service commission can, with the appropriate State legislation, effect some change in the manner of rate increases granted to some utility companies.

Not so with natural gas.

It is a very much misunderstood factor among all of the States. With natural gas, our hands are tied at the State level by the 1978 Natural Gas Policy Act, which controls gas prices in interstate commerce.

Because almost all of Indiana's gas is supplied from sources outside the State, our public service commission is restricted by Federal law from holding gas prices down—which brings me to Washington, and this hearing today.

For it is not the Indiana general assembly, nor the Indiana Public Service Commission, nor the Governor of Indiana who can make a substantive change in today's prices of natural gas. It is the

Congress—and Congress alone—which has such substantive authority.

I am heartened that action to resolve this complex dilemma is underway. I respect you, and I applaud you for doing so.

A reasonable place to begin a dialog for change is with the proposals submitted by the Reagan administration and the subject of this hearing.

Allow me to comment just briefly on what I believe to be the positive points of the President's plan.

First, I support deregulation by January 1, 1986, in theory.

Now, especially, with the price of competitive fuels coming down, it is the time for the production and marketing of natural gas to participate in the free marketplace.

It is time that the law of supply and demand dictate the pricing of this commodity rather than Government continuing to create an artificial schedule unresponsive to the needs of the consumer.

However, I am reluctant to embrace deregulation in total until further review has been conducted on the impact of including old gas in overall decontrol. I am reminded of the fact that old gas represents two-thirds of the gas that is utilized in Indiana.

In the entire Midwest, it is high. Old gas is indeed high in every State.

Second, it is important—perhaps even vital, that during the transition period of the deregulation, that the consumer be protected from further increases.

To a great extent, the President's proposal addresses this concern but not entirely.

I support the provision for a price ceiling, and a cap on gas escalators.

I support a reduction in the level of gas required to be taken, under "take-or-pay" provisions.

The President's plan would require pipelines to take only 70 percent of the gas that they contracted for. I am not sure that is enough.

I believe you must consider means to obtain actual price reduction by elimination of the 'take-or-pay' element in contracts. That may be the only way to be certain to reduce the onerous effect of the present contract provisions.

I support the proposal allowing pipelines to transport gas regardless of the buyer or seller.

I support the elimination of any automatic pass-throughs higher than the rate of inflation.

The Federal Energy Regulatory Commission must be charged with the duty to determine whether such purchased gas costs are just and reasonable expenses.

Language must be added to the NGPA statute that would allow the Regulatory Commission to disallow contracts which demonstrate imprudence on the part of the pipeline companies in purchasing supplies of gas.

Third, during this time of deregulation, we must also seek every sensible means to keep present industrial customers on the gas system.

The elimination of the Fuel Use Act and incremental pricing goes a long way toward accomplishing this goal.

The need to maintain industrial gas consumers is yet another reason to begin orderly decontrol to force the price of gas below that of alternative fuets.

Unfortunately, Indiana is handicapped in terms of use of other types of energy. The best alternative for many Hoosier businesses is coal, but because of various environmental regulations, they are deprived of that alternative.

Thus, we have the situation of industrial customers switching from gas, the majority of which is found domestically—to oil, a large portion of which comes from foreign sources.

I think it is important for me to add to my testimony that you must look at squarely the special problem of foreign gas, of imports. Algerian gas, which particularly hits the major pipeline moving in Indiana, is one in particular that needs a hard look.

Canadians may be more reasonable, but most particularly, we need to assure ourselves that there is no alternative. There needs to be in my opinion support for Secretary Hodel's concept that there must be some means by which we can apply pressure down through this distribution system from the consumer clear back to the sources of supply.

As you may be aware, the Governors of the 50 States addressed the issue of natural gas price controls at their meeting in Washington early last week, continuing a dialog on this subject that began last August at the Governor's annual meeting in Oklahoma.

My point in mentioning both meetings is to assure you that the Governors' recommendations have not been hastily conceived or lightly discussed. The NGA energy and environment committee chaired by West Virginia Governor Jay Rockefeller has devoted a major portion of its last two meetings in a substantive detailed and at times heated discussion on natural gas.

Although the development of recommendations on natural gas pricing was not easy, a large majority of the Governors voted to approve a statement for the record on behalf of a revised NGA policy on February 28, 1983. It revised their policy from one that had been created subsequent to the NGPA.

I am submitting this policy statement for the record on behalf of the National Governors Association. It is important for me to say that as a consensus view, it takes a remarkedly strong position.

Gas price escalation is indeed an incendiary issue across a broad sweep of the States, running all the way from the Rocky Mountains to the east coast.

I would like to close my testimony with this thought. Although deregulation may ultimately be the answer to the gas problem, an aroused and angered public may never allow decontrol to happen. Consumer protection during this transition period must be accomplished. I echo what was said by Senator Specter on that point.

Even if your actions are able to stabilize current rates, when next January and a normal winter returns, gas consumers' bills will still be higher than this year's. Irate Hoosiers will be even madder than they are now.

It could be that various measures include some rollback of prices will be necessary to guarantee relief for consumers. Therefore, the task before you is twofold. First, you must gain control of the gas market, and provide for a return to some semblence of order for the future. Second, you must gain the confidence of the public by demonstrating that the actions that you are taking are correct, and will have beneficial results in the long run, so that they will be supported.

Keeping the status quo will only invite further public revolt. It is absolutely no solution, since price escalation will certainly continue. There is talk of deliberate consideration by Congress of the natural gas problem.

We read that Members of the Senate will filibuster to death any attempt to modify the Natural Gas Policy Act. It is hard for me to believe that some in Congress would choose to commit political suicide by failing to take prompt action. Surely, such Members must be deaf to the shrill outrage of the public.

I urge you to act with expediency on this urgent matter. Do not be lulled by any diminishment of public clamor during the warm spring and summer months. It is a lead-pipe cinch that if something is not in place by the late summer, and if Mother Nature's performance is back to normal, then we as public officials will be virtually smothered in an avalance of protest shortly thereafter.

Congress will have lost the good faith and support of those that you and I are trying earnestly to serve. I thank you, very much for the opportunity.

[The prepared statements of Governor Orr follow:]

TESTIMONY OF GOVERNOR ROBERT D. ORR
BEFORE THE ENERGY & NATURAL RESOURCES COMMITTEE,
U. S. SENATE

10:00 am, Friday, March 11, 1983

Mr. Chairman, members of the committee, my name is Robert Orr, governor of the State of Indiana. Thank you for the opportunity to speak today on behalf of the five-and-a-half million citizens of the Hoosier state.

We Hoosiers by tradition are a common sense people...a self-reliant lot. We work hard to support our families and to preserve a lifestyle we believe second to none. We tithe to our churches. We support our communities. We raise our children to be proud of a heritage of independence and a pioneering spirit.

Only in extraordinary circumstances will you find a Hoosier on the doorstep of Congress asking for special consideration. In fact, Indiana historically has rendered more in fiscal dues to the federal government than we've gotten back in services. We're known as a major donor state.

These past two years have not been ordinary times for our people, however. On any given week during 1982, as many as 300,000 Hoosiers were out of work. Our unemployment rate has consistently been 3 to 4 points higher than the national rate. In some of our communities, for every 80 people working there are 20 without jobs. State government has had to balance steadily declining income with ever increasing calls for help.

Even now this tenacious recession continues its grip on Indiana. Any loosening is expected to be a slow, deliberate process.

Added to the menace of recession in recent months has come another peril which has so frustrated Hoosiers, so rankled us, so evoked our anger that I am here today to relay the message loud and clear--we're mad as hell, and we cannot take it any longer!

The source of our wrath? The rapid escalation of natural gas prices.

In the last 12 months, the average citizen of Indiana has seen his gas bills increase by 40 to 50 percent due primarily to pricing practices allowed under the Natural Gas Policy Act of 1978 and followed by the Federal Energy Regulatory Commission.

Recent increases resulting from the latest round of supplier gas purchases have added anywhere from 24 to 56 percent more on to the customer's bill depending on the particular gas pipeline and gas distributing company.

The strain of high gas bills weighs heavily on all Hoosiers...from our elderly on fixed incomes...to our unemployed, who've been knocked down once by the loss of their livelihood only to take repeated blows each time they open a heating bill...to the backbone of our Hoosier populace, the middle class families, who a year ago were able to sock away a little extra toward their children's college education, but today shake their heads in bewilderment because all the extra has been swallowed up by increasing utility costs.

Never have I as a public official received so much mail on a single situation. Most of my correspondence expresses confusion and disbelief that in a free market society such as ours the laws of supply and demand aren't working. Some Hoosiers contact me out of sheer desperation, such as a woman from southern Indiana who writes, and I quote from her letter, "We are of modest means, but the 40 percent increase in the gas bill can come only out of the meager amount we have set aside for food each week. We keep the thermostat down so we are always cold, and we have had a mild winter, yet the gas bill is $145!!! It has never been over $100 because we have only a small six-room house. This is just too much!"

Another Hoosier writes, "When people have to decide whether they want to stay warm or eat, something is wrong."

Individuals aren't the only ones affected by exorbitant gas bills. Business, especially small business, has also been hurt by skyrocketing gas costs. Many businessmen are caught between a rock and a hard place trying to decide whether to pay the gas bill or call back 10 workers from furlough. In this instance, when the gas company wins, our economy loses.

Economic recovery in Indiana and nationwide can only be hampered by the continuance of gas price increase after increase.

Remember, homeowners can look forward to some relief as the spring and summer months come upon us. But for the businessman who uses natural gas in processing, there is no impending relief. His costs will only go up, up and up.

One employer in Indianapolis tells me that his gas bill for December of 1982 reflected a 53 percent increase over his bill of the year before, and he's been using less gas! He views this large an increase in a one-year period as "totally unreasonable, unfair and unjustifiable. It represents," he writes, "an incredible breach of the public trust."

Schools, government, hospitals and other public or quasi public institutions are caught in the same gas squeeze. Back in the winters of 1976 and 1977, some Indiana schools closed their doors temporarily because of gas shortages. Today the doors are being closed on the development of many new programs in our schools because the necessary funds are being diverted to pay higher utility bills.

The one common thread weaving throughout my correspondence and conversations with Hoosiers is that they are frustrated, confused and in great need of relief.

Fortunately for those in the most desperate straits, our emergency assistance program, Project SAFE, has been able to alleviate some of the hopelessness of not being able to meet utility bills. Thus far in the heating season we've helped 170,000 households and we're still getting applications. We've obligated $37 million to aid people through this program, and it's my guess that we'll have to stretch that sum down to the last dollar to ensure that the heat stays on in the homes of the elderly and the poor.

For many Hoosiers there seems to be a high degree of confusion about just who in government is the appropriate source of relief. They very often point their finger to our state Public Service Commission and say "do something."

To a very limited extent the PSC can, with the appropriate state legislation, effect some change in the manner of rate increases granted to utility companies.

Not so with natural gas. With natural gas, our hands are tied at the state level by the 1978 NGPA which controls gas prices in interstate commerce. Because almost all of Indiana's gas is supplied from sources outside the state, our Public Service Commission is restricted by federal law from holding gas prices down.

Which brings me to Washington and this hearing today. For it is not the Indiana General Assembly nor the Indiana Public Service Commission nor the governor of Indiana who can make any substantive change in today's prices of natural gas. It is Congress and Congress alone who has such substantive authority.

I am heartened that action to resolve this complex dilemma is underway. A reasonable place to begin a dialogue for change is with the proposal submitted by the Reagan administration and the subject of this hearing today.

Allow me to comment just briefly on what I believe to be the positive points of the president's plan.

1) I support deregulation by January 1, 1986, in theory. Now, especially with the price of competitive fuels coming down, is the time for the production and marketing of natural gas to participate in the free marketplace. It's time that the law of supply and demand dictate the pricing of this commodity, rather than government continuing to create an artificial schedule unresponsive to the needs of the consumer.

However, I am reluctant to embrace deregulation in total until further review has been conducted on the impact of including "old" gas in overall decontrol.

2) It is important that during this transition period to deregulation the consumer be protected from further increases. To a great extent the president's proposal addresses this concern.

I support the provision for a price ceiling and a cap on gas escalators.

I support a reduction in the level of gas required to be taken under take-or-pay provisions. The president's plan would require pipelines to take only 70 percent of the of gas they contracted for.

I believe you must consider means to obtain actual price reductions by elimination of the take-or-pay element in contracts. That may be the only certain way to reduce the onerous effect of this present contract provision.

I support the proposal allowing pipelines to transport gas regardless of the buyer or seller.

I support the elimination of any automatic pass-throughs higher than the rate of inflation. The Federal Energy Regulatory Commission must be charged with the duty to determine whether such purchased gas costs are just and reasonable expenses.

Language must be added to the NGPA statute that would allow the regulatory commission to disallow contracts which demonstrate imprudence on the part of the pipeline companies in purchasing supplies of gas.

3) During this time of deregulation, we must also seek every sensible means to keep present industrial customers on the gas system. The elimination of the Fuel Use Act and incremental pricing goes a long way toward accomplishing this goal.

The need to maintain industrial gas consumers is yet another reason to begin orderly decontrol to force the price of gas below that of alternative fuels.

Unfortunately, Indiana is handicapped in terms of use of other types of energy. The best alternative for many Hoosier businesses is coal, but because of various environmental regulations they are deprived of that alternative. Thus we have the situation of industrial customers switching from gas, the majority of which is found domestically, to oil, a large portion of which comes from foreign sources.

As you may be aware, the governors of the 50 states addressed the issue of natural gas price controls at their meeting in Washington last week, continuing a dialogue on this subject that began last August at the governor's annual meeting in Oklahoma.

My point in mentioning both meetings is to assure you that the governors' recommendations have not been hastily conceived or lightly discussed. The NGA Energy and Environment Committee, chaired by West Virginia Governor Jay Rockefeller, has devoted the major portion of its last two meetings to substantive, detailed, and at times heated discussions on natural gas. Although the development of recommendations on natural gas pricing was not easy, a large majority of the governors voted to approve a revised NGA policy on February 28, 1983. I am submitting this policy statement for the record on behalf of the National Governors' Association. As a consensus view, it takes a remarkably strong position. Gas price escalation is indeed an incendiary issue across a broad sweep of the states.

I would like to close my testimony with this thought. While deregulation may ultimately be the answer to the gas problem, an aroused and angered public may never allow decontrol to happen. Consumer protection during this transition period must be accomplished.

Even if your actions are able to stabilize current rates, when next January and a normal winter comes, gas consumers' bills will still be higher than this year's! Irate Hoosiers will be even madder than they are now.

It could be that various measures, including some rollback of prices, will be necessary to guarantee relief to consumers.

Therefore the task before you is twofold: First, you must gain control of the gas market and provide for a return to some semblance of order for the future. Secondly, you must gain the confidence of the public by demonstrating that the actions you are taking are correct and will have beneficial results in the long run.

Keeping the status quo will only invite further public revolt. It is absolutely no solution since price escalation will most certainly continue.

There is talk of deliberate consideration by Congress of the natural gas problem. We read that members of the Senate will filibuster to death any attempt to modify the Natural Gas Policy Act.

It is hard for me to believe that some in Congress would choose to commit political suicide by failing to take prompt action. Surely such members must be deaf to the shrill outrage of the public.

I urge you to act with expediency on this urgent matter. Don't be lulled by any diminishment of public clamor during the warmer spring and summer months. It is a lead pipe cinch that if something is not in place by late summer and Mother Nature's performance is back to normal, then we as public officials will be virtually smothered in an avalanche of protest shortly thereafter. Congress will have lost the good faith and support of those that you and I are trying earnestly to serve.

Thank you.

Testimony of

Governor Robert D. Orr
Indiana

on behalf of

The National Governors' Association

before the

Committee on Energy and Natural Resources
U.S. Senate

March 11, 1983

Mr. Chairman, members of the Committee, my name is Robert Orr, Governor of the State of Indiana. It is a pleasure to be here today on behalf of the National Governors' Association. The NGA very much appreciates the opportunity to offer recommendations on natural gas regulatory policy -surely one of the most difficult issues facing the Congress and the American people today.

As you may be aware, the Governors addressed the issue of natural gas price controls at their meeting in Washington last week, continuing a dialogue on this subject that began last August at the Governors' annual meeting in Oklahoma. My point in mentioning both meetings is to assure you that our recommendations have not been hastily conceived or lightly discussed. The NGA Energy and Environment Committee, chaired by West Virginia Governor Jay Rockefeller, has devoted the major portion of its last two meetings to substantive, detailed, and at times heated discussions on natural gas. Although the development of recommendations on natural gas pricing was not easy, a large majority of the Governors voted to approve the NGA policy, a copy of which is attached to my statement.

Some of you may wonder why the nation's Governors would devote so much time and effort to the question of natural gas pricing, when the states have no responsibility for implementing the NGPA and very little control over interstate gas pipelines. The answer is simple: we are concerned about the tremendous impact of recent natural gas price increases on our citizens, businesses, and economies. In Indiana, I have received more mail in the last year on the natural gas issue than on virtually any other. The people of Indiana and many other parts of the country have been stung by the 20%-25% increase in natural gas prices over the past year. We are extremely concerned about the prospects for further price increases in the years ahead, particularly in the face of abundant gas supplies and reports of large quantities of inexpensive, price controlled gas being shut-in at the wellhead. It appears to the Governors that there are serious distortions in the natural gas markets, distortions which threaten all gas consumers, residential and business users alike. The best interests of our states, then, are very much at stake in this issue.

Governors' Recommendations

Indefinite Price Escalators

In its broad context, the NGA policy on natural gas supports the phased deregulation of new gas wellhead prices as provided by the NGPA, and supports an excess profits tax on gas producers. In addition, we believe it is imperative that Congress take action now to protect consumers and ensure adequate gas supplies by restoring order to natural gas markets and acting to equalize and reduce natural gas prices. We urge the Congress to restrict gas industry practices which tend to artificially inflate prices by undermining market forces which would otherwise be at work. Two of the most common industry practices which undermine market forces are indefinite price escalator clauses and take-or-pay contracts. As I am sure you are aware, indefinite price escalators are clauses which tie the future delivered price of new gas under contract to the price of oil products or to the highest gas price being paid in a particular gas field at that future time. Most of these clauses are to be triggered when new gas is decontrolled in 1985 under the NGPA. Often these clauses, when triggered, will take the gas to which they apply to a price substantially in excess of what is believed to be the market clearing level. These clauses are ticking time bombs affecting over 70% of gas brought into the market since 1978, according to the Department of Energy. The economic shock caused by these rapid and widespread price increases will be felt throughout the nation. It is important to note that interstate pipelines have considerably more gas subject to indefinite price escalators than do intrastate pipelines, so that consumers of interstate gas will bear the brunt of such increases.

Take-or-Pay Contracts

The other troublesome industry practice I mentioned is the inclusion of take-or-pay provisions in many contracts. These provisions require pipelines to pay for a given volume of the gas under contract, even if the pipeline can't market the gas at that price, has an excess of supply, or has other cheaper supplies available. In 1980, the average contract volume required to be taken or paid for anyway under such provisions was 79%, according to the DOE. As gas demand has dropped due to conservation and the recession, some pipelines have been forced to curtail older less expensive gas contracts in order to meet take-or-pay requirements in newer, more expensive contracts. The result is a gas supply mix that contains more new expensive gas and less old cheap gas than it could or should, with gas consumers paying more than they ought to. That situation cannot be allowed to continue.

The Governors recommend that Congress enact legislation inserting a market-out clause in all existing contracts which contain take-or-pay and/or indefinite price escalator clauses. Such a provision will allow pipelines to renegotiate these contracts and eliminate the excessive burden now being borne by consumers.

Automatic PGA Pass-Through

In addition to the market distortions caused by industry practices which undermine market forces, some of the regulatory practices of the Federal Energy Regulatory Commission do not encourage pipelines to negotiate aggressively to obtain gas supplies at the lowest possible cost. In particular, the automatic pass through to consumers of any prices that pipelines pay to obtain gas supplies - the so called purchased gas adjustment (PGA) - insulates pipelines from any risk that their stockholders may have to bear some of the cost of excessively high priced gas contracts. The Governors believe that pipelines as well as producers should be subject to greater market discipline in order to help equalize and reduce prices. Specifically, section 601(c) of the Natural Gas Policy Act should be amended to bar the automatic pass through of purchased gas costs and to require the FERC to determine whether such purchased gas costs are just and reasonable expenses incurred through prudent decision making and management practices.

Other Measures

While the Governors are convinced that the measures we have suggested will help restore needed order to natural gas markets and reduce prices, there may be other steps which would be compatible with the lowest possible consumer gas prices and the maintenance of a healthy domestic gas industry. We believe that the FERC should hold at least five regional hearings within 12 months of enactment of reform legislation, to identify, examine and subsequently adopt such steps administratively.

Windfall Profits Tax

As I mentioned earlier, the NGA policy on natural gas includes a recommendation for a windfall profits tax on natural gas producers. Gas producers - principally the major oil companies - may realize profits of more than $40 billion between 1985 and 1990 as the result of the decontrol of old gas, according to a recent estimate cited in the Washington Post. The marginal cost of producing gas at many of these old wells is literally only pennies per MCF. Partly for this reason, the Governors have never suggested that old gas should be decontrolled. But if it were, it seems reasonable to us that the public rather than gas producers, ought to realize that additional revenue. If decontrol of old gas is needed to help restore order to natural gas markets, then the windfall generated should flow back to consumers through the public treasury. The Governors specifically recommended that these revenues should be used for energy assistance to individuals on fixed and low incomes, and that credits against the tax should be permitted where excess earnings are plowed back into the exploration and development of new natural gas supplies.

The Administration's Decontrol Plan

While my primary intention here today has been to describe the Governors' affirmative recommendations regarding natural gas policy, I would also like to briefly describe our reaction to the Administration's natural gas decontrol plan. The Governors did not have the opportunity to examine the Administration's plan in detail before their recent meeting, but did recognize it as a creative first step, and perhaps a reasonable place to begin the dialogue on natural gas issues. The principal differences between the Administration's plan and the Governors' recommendations lie in two areas: 1) whether it is wise to decontrol old gas, and 2) how the relative balance of incentives between gas producers and pipelines should be structured. In the first area, as noted earlier, the Governors believe that contract problems can and should be addressed forcefully and effectively, without the decontrol of old gas.

As regards incentives, the main thrust of the Administration's plan is to encourage the renegotiation of contracts between pipelines and producers in a decontrolled environment. While the NGA recommendation would allow pipelines to eliminate completely take-or-pay requirements and immediately renegotiate such contracts, the Administration's plan would allow pipelines to reduce take-or-pay requirements only to 70%. Given that take-or-pay requirements averaged 79% of the volume in the average new contract in 1980, the reduction to 70% may not be enough to have any significant impact on gas prices in the near term.

The Governors' proposal also differs from the Administration plan in a second key respect. The Administration proposal would allow all currently existing contracts to be broken by either the producer or the pipeline after January 1, 1985. This would include both contracts that contain take-or-pay or indefinite price escalator clauses as well as existing contracts for old and new gas which contain no such provisions. Our proposal limits the market-out opportunity only to contracts which contain take-or-pay and/or indefinite price escalator clauses and limits the opportunity to exercise the market-out option to the gas purchaser, the pipeline company. In this regard, the NGA proposal is more limited and designed to insure that current contract abuses are corrected and that excessive gas prices that have resulted from such contract problems are reduced.

Both the Administration proposal and the NGA proposal provide further encouragement to the pipelines to utilize the market-out option provided. Both proposals call for

Congress to prohibit the automatic pass through of purchased gas costs by FERC and suggest that FERC should review each new purchase contract to ensure that the purchase is a prudent one.

In summary, the heart of the difference between the NGA proposal and the Administration proposal is the emphasis on decontrol of old gas contained in the Administration proposal. The NGA proposal is designed to address the most pressing problem before us: the excessive increase in natural gas prices that has been caused by faulty contract provisions and lax FERC regulation. The Governors' proposal does not venture into the uncharted waters of old gas decontrol. As such, we feel our proposal can make a real difference in the adverse impact on consumers. We cannot be certain of the impact of the Administration proposal in this regard, as it appears that it may well provide greater incentives to producers to renegotiate than to pipelines and could result in gas price increases.

We recommend that in considering the natural gas decontrol issue, the Congress look very carefully at the relative balance of risk and incentive provided to pipelines and producers and again commend the recommendations of the National Governors' Association to your attention. Your attention and interest in our views is appreciated and we look forward to working with you in the months ahead in the effort to forge needed changes in natural gas policy which protect the consumer and ensure adequate supply in the future.

D. - 13

NATURAL GAS

The total resource of domestic fossil fuels is finite, and the total annual production of energy from these sources is limited. Natural gas is the most environmentally acceptable~~,~~ AND readily usable~~, and least expensive~~ fuel. This has led to the rapid exploitation of available supplies.

~~Since 1968, production of natural gas has exceeded additions to inventory.~~ Future natural gas curtailments are expected to cause increased distortion and dislocation in the economy. Even with stringent conservation, discovery of new gas fields will be needed to provide lead-time while alternate energy resources are developed.

Federal price policies historically undervalued interstate gas in relation to other fuels. This resulted in lowered incentives for exploration, an artificially high demand, and few incentives for conservation.

The National Governors' Association has supported the deregulation of new gas wellhead prices and recommended an excess profits tax on gas producers, with relief from such tax if excess earnings were plowed back into the exploration and development of new natural gas supplies. In addition, a portion of the revenues from such a tax should be used for energy emergency impact assistance programs for individuals on fixed and low incomes.

NGA urges Congress to consider restrictions on industry practices which tend to inflate prices artificially by undermining market forces which would otherwise be at work, such as take-or-pay and indefinite prices escalator clauses in natural gas purchase contracts. CONGRESSIONAL ACTION IS NEEDED TO RESTORE ORDER TO NATURAL GAS MARKETS, TO INCREASE COMPETITION, AND TO EQUALIZE AND REDUCE NATURAL GAS PRICES, *in order to protect consumers and ensure supply.* SPECIFICALLY, THE GOVERNORS RECOMMEND THAT CONGRESS ENACT LEGISLATION TO:

1. INCLUDE IN ALL EXISTING AND FUTURE NATURAL GAS CONTRACTS WHICH CONTAIN TAKE-OR-PAY OR INDEFINITE PRICE ESCALATOR CLAUSES A MARKET-OUT CLAUSE ALLOWING THE PURCHASER TO REFUSE TO TAKE GAS SUPPLIES WITHOUT INCURRING ANY PENALTY AND TO RENEGOTIATE THE CONTRACT.

2. AMEND SECTION 601(C) OF THE NGPA TO REMOVE THE GUARANTEED PASS-THROUGH OF NATURAL GAS PURCHASE COSTS AND INSTEAD REQUIRE THE FERC TO DETERMINE WHETHER THE PURCHASE GAS COSTS ARE JUST AND REASONABLE EXPENSES INCURRED THROUGH PRUDENT MANAGEMENT AND OPERATION OF THE COMPANY.

3. REQUIRE THE FERC TO HOLD AT LEAST FIVE REGIONAL HEARINGS WITHIN 12 MONTHS OF ENACTMENT TO EXAMINE AND SUBSEQUENTLY ADOPT METHODS TO INSURE THE LOWEST POSSIBLE CONSUMER GAS PRICES CONSISTENT WITH THE MAINTENANCE OF A HEALTHY DOMESTIC NATURAL GAS INDUSTRY.

In addition, the administration and the Congress should consider measures to assure equal access to all natural gas supplies to both interstate and intrastate natural gas pipelines.

Development of legislative and executive commitments to determine national priorities for use of natural gas, specific programs designed to promote natural gas conservation, and a major effort to convert and phase out as rapidly as possible those existing natural gas facilities that do not represent the wisest and best use of natural gas under current circumstances would prevent accelerated depletion of remaining supplies of natural gas, which could result from deregulation.

There is evidence of vertical and horizontal integration and interlocking relationships among natural gas producers and purchasing pipelines. There is also evidence of integrated and interlocking relationships among natural gas, petroleum, coal and uranium mining firms.

These conditions may result in an anticompetitive aspect of the energy industry which could cause an artificial inflation of the price of natural gas and other energy supplies.

Developments in the energy industry should be closely monitored to determine whether the letter and spirit of national antitrust laws are respected fully.

The administration and Congress should take prompt action to facilitate the earliest availability of natural gas from the Arctic slope to markets in the Midwest, East, Middle South and Pacific Coast states. This resource, essential to the health of these sections of the United States, must not be withheld because of delays in administrative agency approval or unnecessarily extended court proceedings.

Adopted July 1976; revised August 1980 and August 1982.

The CHAIRMAN. Governor Orr, every once in awhile in your testimony, you strike a chord that elicits a response from me. In the midst of the earlier part of your statement, you said something that was a real flash of inspiration to me. You said that you responded to people in Indiana by saying it is not our fault, State government does not have anything to do with it.

Maybe the answer for us is to simply delegate this problem back to the States.

Governor ORR. We would deal with it, if we could.

The CHAIRMAN. Well, I think that a lot of us up here would welcome that relief. But I say that flippantly, obviously.

Governor ORR. May I respond to that, Mr. Chairman?

The CHAIRMAN. Surely.

Governor ORR. The problem, as you well know, began back in the early 1950's when the Congress assumed responsibility to control the wellhead price.

The CHAIRMAN. Yes, sir, I agree with that. And one of the problems that confronts us, of course, is anytime you change the rules, you affect somebody adversely. You suggested at one point, as Senator Specter did earlier, that we have to look at the people who relied on the 1978 act, who went out and contracted for the production of or the purchase of high-cost gas, gas that did cost a lot more to produce.

And I suppose that there is a way in which you can hold them harmless from changes in the law now by subsidizing them directly from the Treasury. Force them to sell their gas at low cost, and simply subsidize the producer in order to protect him against the change of policy. But I do not suspect that that is a very popular notion either.

Senator Ford.

Senator FORD. Thank you, Mr. Chairman.

May I welcome my neighbor to Washington. And having been in your shoes several years ago, I was there during the shortage. You are there now during the high prices.

Governor Orr. I was there during the shortage, too.

Senator FORD. I know, but I had to drive the truck. [Laughter.]

You make an interesting statement. And I agree with the chairman that it is awfully easy to take care of my State, as long as I have the wherewithal to take care of it.

We saw shortages in the early 1970's, and tried to bring something to the consumer States. You mentioned imports of natural gas, which struck a bell with me.

Does not Indiana use a lot of Canadian gas?

Governor ORR. Some. It uses it under present circumstances because of one particular pipeline, the panhandle. Now it is beginning to use substantial quantities of Algerian gas.

Senator FORD. Well, the President's bill, as I see it, President Reagan's bill, does not limit or otherwise touch gas imports. And this bill that some are embracing would not help you very much, if your source of natural gas was Canadian gas.

Governor ORR. I identified the problems of imported gas not being covered.

Senator FORD. Do you have any thoughts as to how we ought to handle that issue, because it directly affects Indiana?

Governor Orr. Senator, I wish that I had an answer for you. I do not. It is a very complex issue, I recognize going beyond simple economics. It gets into the field of diplomacy. It is my understanding from some conversations that I have had with some officials, that the Canadian Government, the Canadian people, the Canadian producing companies, are more understanding of the need for some consideration than perhaps maybe a power across the water.

But I have no basis for knowing anything more than that simple statement.

Senator Ford. I may be wrong, but I think that the average price at the Canadian border is about $5. And the Canadian Government has said fellows, go make the best contract you can with the Americans, because the way they are going they will have another shortage by 1986 or 1987. Maybe they pay more attention to our problems than we do.

So if we are going to have a shortage within a couple of years, you will be back up here saying do something about getting some more gas. So we have got to weave a pretty comprehensive program. But when we make it comprehensive, then we get fussed at for making it comprehensive.

You know, there is no way to win here. Daviess County, my home county, says we will go to Frankfort. When I was in Frankfort, we said we will go to Washington to get it. Somewhere you have to stop, and it stops here.

So you talk about low-cost gas. You worry about that under this bill, deregulating low-cost gas, or the old gas. Well, some have advocated a windfall profits tax, or excess profits, or an excise tax, or something similar to that.

Would you support something similar to that?

Governor Orr. I am not sure that I would. I think that it is perhaps appropriate for me to mention, particularly because some discussion came up between you and Senator Specter at the last hearing, that the breaking of contracts is something that is very difficult to do in our society.

I am not a lawyer, as you indicated you are not one.

Senator Ford. We could probably write a pretty good contract.

Governor Orr. I would not be at all surprised, Senator. But I am advised that abrogation, that may be the wrong word, but derogation is one which means to reduce the effect. And an adhesion contract, where one party has two superior an advantage over the other. Maybe there is a point of law that could be applied to these kinds of circumstances where the contracts simply are irrelevant today, even though they may have been very relevant a few years ago.

It takes an unfair advantage, in other words, under present circumstances. And there may be some means by which that whole problem can be attached through that mechanism.

Senator Ford. I may be mistaken, but did not the Governors Conference take a position as related to a windfall profits tax, or an excess profits task. I thought that you all had taken a position on that.

Governor Orr. We have taken somewhat different positions, which is one of the reasons why I gave emphasis to the Indiana problem, rather than to that of the Governors.

Senator **Ford**. I thought that you were here representing the Governors and their position.

Am I wrong?

Governor **Orr**. I attempted to identify my position as being both that of presenting the NGA policy as well as presenting that of the Indiana position.

The windfall profits tax is identified here. And it does include a recommendation for some windfall profits tax on natural gas producers. This was one of those elements in the policy which created a good deal of difference of opinion. And I happen to be one of those that while I voted in favor of the overall policy, as one must do under those circumstances, I am not overly in favor of too much of that sort of activity.

It seems to me that we have enough at the present time of discouragement for finding resources.

Senator **Ford**. Governor, if this became a reality, the excess profits or windfall profits tax, however you want to refer to it, did the Governors have a rate that they would recommend?

Governor **Orr**. No, sir.

Senator **Ford**. Did they have a recommendation as to whether this tax would be earmarked for any particular operation?

Governor **Orr**. No.

Senator **Ford**. I am talking about fuel assistance, or weatherization.

Governor **Orr**. Oh. Well, yes, I think that all of them recognizing the need for fuel assistance would believe that that would be a logical place for such funds to go. We are all struggling with that problem with ever increasing and ever mounting difficulty.

Senator **Ford**. We listened to testimony yesterday, and trying to find the trigger in my own mind having been there, and understanding some of your problems—it has been 10 years, so the problems have changed considerable—the testimony yesterday was somewhere on the average of 300,000 American homes nationwide had had their utilities turn off natural gas.

And I was concerned that we were here setting a policy that would affect 300,000 homes that has the utilities or natural gas cut off, when we are trying to take care of over 200 million.

I was wondering if we could set a policy that would basically affect the 200 million while with fuel assistance we would take care of those really hard pressed.

Would that make any kind of good sense to you as a Governor?

Governor **Orr**. Well, let me answer your question this way. That in the State of Indiana under our Project SAFE, which is fuel assistance, the gas is not shut off. We have mechanisms for working that out. So the 300,000 homes referred to would not actually be affected under any circumstance.

We have a means by which we attempt jointly to take care of it. Our utilities, the gas utilities, do so. We supply the Project SAFE money.

I think that we have to look at it from the standpoint of all of the American citizenry. And that was really part of the thrust of my testimony. It is now reaching into all levels of business, the smallest business, and the very largest business.

Indiana's steel industry, now ranks first in the Nation, and it is in serious jeopardy, because of its dependency on natural gas. And it obviously has a serious difficulty in trying to convert many of those processes away from natural gas to coal, because of environmental considerations.

I do not think that we can afford to cause any further problems for a major employer in the country under these circumstances. So it is not the company that I am concerned about. It is the return to work of the people who normally are employed in big industry; the steel industry, the aluminum industry, and so on.

Senator FORD. I thank you, Mr. Chairman.

Thank you, Governor.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I'll wait to hear the witnesses.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I have a couple of quick questions for the Governor, who I want to welcome to the committee. It is good to see you.

One of the central issues, of course, is the decontrol of the old gas, which as I understand the NGA's position, they favored decontrol of the old gas with the windfall profit tax. My question I suppose is this. Unlike oil where the decontrol of old oil was, I think, correctly justified on the ground that it would give people an incentive for enhanced methods of recovery—secondary, tertiary.

It is very difficult to achieve any enhanced recovery from an old gas well. I am no expert on it, so I can't say you can't do it. I don't know that for a fact. My understanding is that it is almost impossible most of the time.

Now, assuming that that is correct, why would it not be the case, assuming that we do get a marketplace that reflects the proper play of supply and demand forces between the purchasers of gas and the producers of gas and that that market price will settle out at the appropriate level, why would it not be true that decontrol of old gas, returning as it would revenues to a particular set of producers, would reduce the amount of revenues to go to find more new gas supply? Why would, in other words, would not the decontrol of old gas result in finding less new gas?

Governor ORR. Why would——

Senator HEINZ. Why would not——

Governor ORR. Would not.

Senator HEINZ [continuing]. The decontrol of old gas result in their being, if you will, a less incentive, less money, to go out and find new gas?

Governor ORR. Well only, I suppose, the fact that there is eventual exhaustion of the sources of old gas. That would be probably more of an incentive than the price, the ultimate need to stay in business.

Senator HEINZ. Of course, when a producer goes to look for gas, what he is interested in is what kind of a price can he get for it. You are not so interested—as long as there is a market, you just want to be able to make money when you sink that gas well.

Now, clearly the price for new gas, unless I have forgotten my economics, is going to be a little bit higher than a controlled price for old gas. That is the way things would work. If we decontrol old gas, wouldn't it be logical to assume that the price for new gas would come down somewhat?

Governor ORR. I think that is true.

Senator HEINZ. Then if that is true, wouldn't that result in people going out less and looking for new gas? The price would be lower.

Governor ORR. The theory is that the two would come to some degree of balance at a price which would be acceptable. I am not an economist, but I would assume that there would be something rather comparable to that take place, but I think there is a serious question mark in the minds of an awful lot of people.

The point being, there is a psychological factor here. The public is very much alarmed about the concept of decontrol. I tried to make that point.

Senator HEINZ. Now, as I understand both you and the NGA's proposal, you do not provide for any pipeline accountability standards after decontrol on January 1, 1986; is that right?

Governor ORR. I don't think there is anything in there on that particular point, no.

Senator HEINZ. Do you favor pipeline accountability? In effect, FERC oversight to insure that there be prudent purchasing patterns. by the pipelines so that we don't get into the kind of situation we are today?

Governor ORR. It was in my testimony that I thought that that should be language within the statute eventually arrived at so that FERC could operate on that kind of a principle, which at the present time it is my understanding that the language is such as to provide a barrier for their being able to do so.

Senator HEINZ. Now, the President proposes to end that kind of oversight on January 1, 1986, but you would like to see it permanent?

Governor ORR. It seems to me that this is in the same nature as the public service commissions of the respective States have that opportunity in most instances to take a look at the operations of the utilities as to their good management and things of that kind and assure the fact that prices are as good as they can be.

Senator HEINZ. You have a lot of coal in Indiana. Your power companies are subject, when they purchase coal, to that kind of a prudent standard; are they not?

Governor ORR. That is right.

Senator HEINZ. Can you think of any reason why we shouldn't have that as normal operating procedure for natural gas?

Governor ORR. As long as we are regulating, it seems to me that there needs to be that added ingredient.

Senator HEINZ. And I assume because of the somewhat restricted distribution pattern that exists and any time that you build a pipeline or powerline or any kind of public utility, there would be a good case for some kind of regulatory oversight for a good long to come; wouldn't there?

Governor ORR. Unfortunately, I think that is probably the case.

Senator HEINZ. Governor, thank you very much.

The CHAIRMAN. Governor, thank you very much for your own testimony with respect to your representation of the people of Indiana and also for your representation of the National Governors Association here this morning. We very much appreciate your time and your appearance here this morning.

Governor ORR. Thank you for the opportunity to appear.

The CHAIRMAN. Thank you.

We'll next hear from our friend from Illinois, the senior Senator from Illinois, the chairman of the Foreign Relations Committee, Senator Chuck Percy.

You are very welcome before this committee today, Senator. We look forward to hearing from you. Your entire statement will be made a part of the record. You may summarize, if you wish. Address it in whatever way you would like.

STATEMENT OF HON. CHARLES H. PERCY, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator PERCY. Mr. Chairman, I thank you very much indeed, and members of the committee for the opportunity to testify before you this morning. And I want to commend the committee and the chairman for holding this series of hearings on the administration's natural gas proposal.

This proposal is an interesting approach to the disorders that we have seen in the domestic gas market over the past year. There are many uncertainties as to how it will effect consumers in the Midwest and other parts of the country.

The conclusions that you arrive at, Mr. Chairman and members of the committee, from these hearings, will certainly—as to how best address our domestic gas problems—will be important to the Senate and to the entire country.

Today, however, I would like to discuss with you an issue that is not addressed in the President's proposal, the administration's proposal, and issue of immediate concern to citizens not only in the State of Illinois, but other States across the country. And that is the issue involving the continued import of natural gas at market prices, or well above market prices.

This, I hope, will be a subject that the committee will address itself to. As I say, it was not addressed in the President's proposal.

Prices for imported gas are two to three times today what we pay for domestic gas, as we can see from this chart on the right. Note the very significant difference between the prices of Algerian LNG and Canadian and Mexican gas on the one hand, and domestic gas, which is the lower part of the chart, on the other hand.

The large map shows how gas imports affect virtually every region of the United States. In Illinois, for instance, we have 102 counties; 101 of those counties depend upon imported gas for a part of their supplies.

For the past 6 months I have been particularly concerned about the import of exorbitantly priced liquified natural gas from Algeria. The pipeline acquisition cost for this LNG is 2½ times the average for domestic U.S. gas. And where does this gas go? It goes to Illinois, Michigan, Indiana, Ohio, and other very hard pressed economically Midwestern States.

We successfully won a postponement of a pass through of the cost of this LNG to consumers during the winter months. We also have been fortunate to have a relatively mild winter. Eight of my Senate colleagues, including Senators Dixon, Danforth, Lugar, Kassebaum, Dole, Eagleton, Levin, and Riegle, join me in urging the FERC and the ERA to disallow the continuation of these imports at their current very high rate.

But on March 1, the FERC and ERA allowed the pipeline companies shipping the Algerian LNG to pass on these added costs to consumers. This, by itself, will mean as much as a 10-percent increase in gas prices for our already beleaguered consumers and customers.

The FERC and DOE both indicate that they may not tolerate these prices indefinitely, but vague statements of this kind are not enough. Consumers deserve price relief and deserve it soon. That is why Senator Dixon and I have reintroduced our bill, S. 370.

As you know, Mr. Chairman, this bill was referred to the Energy Committee. The Percy-Dixon bill would set an upper limit on the lawful price of regasified LNG. Any price higher than the 90-day average price for No. 6 fuel oil—over the most recent period for which data is available—would, by statute, not be a reasonable price.

After enactment of the Percy-Dixon bill, LNG could be sold at above free-market levels only if alternative domestic supplies to the market served are not available at or below the proposed price, only if the source of supply is reasonably secure, and only if the import agreement includes a provision for reducing quantities of prices if market circumstances change.

If any part of the United States does not have lower priced domestic gas available to replace LNG imports, as, for example, when these imports are serving a peak-shaving purpose, this higher priced LNG can be marketed under our bill.

I want to make clear to my colleagues that our bill is an effort to move toward—not away from—a free energy marketplace. Senator Dixon and I are simply trying to correct the consequences of costly, uneconomic decisions resulting from an overregulated marketplace for natural gas. In a free market, no one vould have ever imported this LNG in the first place, and if anyone had, no one downstream would have bought it.

I further want to make clear that I am a strong supporter of free trade and the inviolability, except in extreme circumstances, of contracts made betweer trading partners. From the beginning, all persons involved in the LNG trade knew or should have known that U.S. administrative agencies, and the Congress, would only allow these LNG shipments to take place if prices are fair and make reasonable economic sense.

The history of LNG trade show unmistakably that price has always been open to discussion.

Up to now, prices have been pushed just upward and upward, as we can well see, but never downward. Now the markets are soft and domestic supplies abundant. It is time that gas prices move down. Our trading partners really understand this. I have talked with Mexican producers. I have talked with Canadian producers, government officials, the ambassadors of all three countries. They realize the reality of life. Oil exporting nations plainly do, and prices are coming down in oil. It is time to tell all gas exporting nations that U.S. companies and U.S. consumers will not tolerate unrealistic prices for gas imports much longer.

I would like to, if Bill Strauss could bring to me a chart showing just the ridiculous situation faced. And I pointed this same situation out to the Canadian Ambassador and to producers in Canada.

Here we have prices coming to Springfield, Ill., and prices at the gate in Toronto. The prices at the gate in Toronto are half the prices as Springfield, Ill., pay. They are double, and yet the natural gas wells are closer to Springfield than they are to Toronto.

Why should the people of Springfield pay when plenty of domestic gas is available twice as much as the people in Toronto farther from those wells? It just simply doesn't make sense to me.

When a soybean processor wrote to me the other day and simply said, "I am going to have to convert my plant, shut down my plant and convert it to another form of energy," I urge our friends in Canada, in Mexico, and in Algeria, to take into account that they cannot be charging two to three times as much as domestic gas when plenty of gas is available and expect us to continue to be long-term purchasers and customers. That doesn't make any sense at all.

This soybean processor is closing his plant, laying off 135 people for 20 months in order to convert away from natural gas to some other form of energy. There is a customer loss, and others are thinking the same thing.

To emphasize the urgency behind the need to see gas prices renegotiated in short order, I have introduced along with Senators Dixon, Johnston, Boschwitz, Kassebaum, Danforth, Burdick, Jepsen, Levin, and Pressler, a resolution calling on the Secretary of State, with assistance from the Secretary of Energy, immediately to enter discussions with nations presently exporting natural gas to the United States, and to report back to the Congress on the progress of these discussions within 30 days.

This resolution is addressed to all of our gas imports—from Canada and Mexico as well as Algeria. Our Government has already begun these conversations with the Canadians, but not with the sense of urgency that I would like to see.

Canada has always been America's closest trading partner, and I have no doubt that the import by the United States of Canadian gas can continue to be mutually beneficial. I recognize, for instance, Mr. Chairman, as you can, that Idaho receives a great deal of Canadian gas. The Canadians have been a secure supplier of gas to both of our States.

But to keep this trading relationship fair, to keep it on a steady basis, to keep it of mutual benefit, the gas must be priced at fair market levels. The Canadians are becoming more and more concerned about preserving future markets. And, after all, 40 percent of their exports come to the United States, and they are beginning to recognize that prices are too high.

The bill before your committee does not extend to the Canadian and Mexican situation. As I stated earlier, the bill was introduced specifically to address exorbitant LNG prices. Senator Dixon and I originally introduced it in the fall. Since then, we have seen very little progress in renegotiating a lower price or a lower take requirement with the Algerians.

I remain hopeful that regulatory relief will be forthcoming, and I would still prefer that solution to this or any other legislative strategy.

But every day that we wait, consumers in Illinois and everywhere in the Midwest are paying for this LNG and workers are losing their jobs as a direct result of high-priced LNG.

In conclusion, Mr. Chairman, I simply say to you and the members of the committee, we cannot really wait any longer. We can't wait because of the long-term, good, sound relationship we want with Canada, we want with Mexico, and we want with Algeria.

At this time we are seeking the committee's support in addressing this issue with the greatest possible speed. I ask that our bill that is before you, or a version of it, be included in a final, domestic natural gas package if one is adopted by the committee.

At the same time, I believe the issue and the bill can and should be pursued administratively as urgently as possible no matter what action your committee takes on the administration's proposal for domestic gas. One way or another, we must solve this problem quickly.

If between now and the passage of this bill, individual parties or the regulatory agencies have worked out a solution, so much the better, and I will certainly happily withdraw the bill. Otherwise, I believe Congress has the responsibility to bring down the high LNG prices for the benefit of gas consumers everywhere.

I believe in the long-range best interests what I hope will be a long term and profitable, mutually profitable relationship, between ourselves and Algeria, just as I hope we will continue to have that long-term relationship that we have enjoyed with Mexico and Canada in the purchase of gas from them.

Thank you, Mr. Chairman.

[The prepared statement of Senator Percy follows:]

STATEMENT OF
SENATOR CHARLES H. PERCY
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
HEARING ON
NATURAL GAS DEREGULATION PROPOSALS

Friday, March 11, 1983

Mr. Chairman, members of the Committee, I appreciate the opportunity to appear before you this morning. I commend the Chairman for holding this series of hearings on the Administration's natural gas proposal. This proposal is certainly an interesting approach to the disorders we have seen in the domestic gas market over the past year. However, I recognize there are still many uncertainties as to how it will affect consumers in the Midwest and other parts of the country. I will be interested to review your conclusions from these hearings on how to best address our domestic gas problems.

I would, however, like to discuss with you today an issue -- an issue of immediate concern to citizens in my own state and other states across the country -- the continued import of natural gas at above market prices. This is not addressed in the Administration's proposal.

Many gas consuming states, including several in the Midwest, have suffered heavily from the current economic recession. Factories and plants have closed, and once prosperous businesses have been forced to lay off employees. Although nationally the economic signs are encouraging, unemployment remains high. Now, in the midst of these economic difficulties, consumers are facing large increases in their natural gas bills -- in part because they are paying super high prices for foreign gas while there is plenty of domestic gas available at much lower prices. This simply makes no sense.

Prices for imported gas are two to three times what we pay for domestic gas, as you can see from this chart. Note the very significant differences between the prices of Algerian LNG and Canadian and Mexican gas on the one hand, the domestic gas on the other. This large map shows how gas imports affect virtually every region of the United States. In Illinois, 101 of our 102 counties receive imported gas.

We should not continue to ask Americans to pay a premium, as we are currently doing, for imported natural gas. This is especially true at a time when many of our domestic producers are forced to shut in their gas wells. Dr. Alice Rivlin, Director of the Congressional Budget Office, concurs with this. She stated, in response to my letter on gas imports, that "there is no economic rationale for continuing to pay prices that are above the competitive level." I will include a copy of this letter with my testimony for the record.

For the past 6 months, I have been particularly concerned about the import of exorbitantly priced liquefied natural gas from Algeria. The pipeline acquisition cost for this LNG is two and a half times the average for domestic U.S. gas. And where does this gas go? It goes to Illinois, Michigan, Indiana, Ohio, and other hard pressed Midwestern states.

We successfully won a postponement of a passthrough of the cost of this LNG to consumers during the winter months. Eight of my Senate colleagues -- including Senators Dixon, Danforth, Lugar, Kassebaum, Dole, Eagleton, Levin and Riegle -- joined me in urging the FERC and the ERA to disallow the continuation of these imports at their current rate. But on March 1st, the FERC and the ERA allowed the pipeline companies shipping the Algerian LNG to pass on these added costs to consumers. This, by itself, will mean as much as a 10 percent increase in gas prices for our already beleaguered consumers.

We are not talking about small change here. We are talking about people's jobs, their daily lives, sometimes their choice between eating and keeping warm. The FERC approved this cost passthrough at the expense of consumers throughout the Midwest. The FERC decision admits that prices are too high, and asks the LNG importers to renegotiate their contracts with the Algerians. The Department of Energy compounded this problem by approving the continuation of these overpriced imports, reaching the astonishing conclusion that it is "premature" to say that these prices are too high.

The FERC and the DOE both indicate that they may not tolerate these prices indefinitely, but vague statements of this kind are not enough. Consumers deserve price relief, and they deserve it soon. That is why Senator Dixon and I have re-introduced our bill, S. 370. As you know, Mr. Chairman, this bill has been referred to the Energy Committee.

The Percy-Dixon bill would simply set an upper limit on the lawful price of regasified LNG. Any price higher than the 90-day average price for Number 6 fuel oil -- over the most recent period for which data are available -- would, by statute, not be reasonable. Even this price is higher than the $2 or $3 per MCF gas now available from many American wells. But it does offer a sensible middle ground, a benchmark around which serious negotiations can begin between buyers and sellers of LNG in the world market.

After enactment of the Percy-Dixon bill, LNG could be sold at above free-market levels only if alternative domestic supplies to the market served are not available at or below the proposed price, only if the source of supply is reasonably secure, and only if the import agreement includes a provision for reducing quantities of prices if market circumstances change. If any part of the United States does not have lower priced domestic gas available to replace LNG imports, as, for example, when these imports are serving a peak-shaving purpose, this higher priced LNG can be marketed under our bill.

I want to make clear to my colleagues that our bill is an effort to move toward -- not away from -- a free energy marketplace. Senator Dixon and I are simply trying to correct the consequences of costly, uneconomic decisions resulting from an overregulated marketplace for natural gas. In a free market, no one would have ever imported this LNG in the first place -- and if anyone had, no one downstream would have bought it.

I further want to make clear that I am a strong supporter of free trade and the inviolability, except in extreme circumstances, of contracts made between trading partners. From the beginning, all persons involved in the LNG trade knew or should have known that U.S. administrative agencies -- and the Congress -- would only allow these LNG shipments to take place if prices are fair and make reasonable economic sense. The history of LNG trade shows unmistakably that price has always been open to discussion.

Up to now, prices have been pushed upward, but never downward. Now that markets are soft and domestic supplies abundant, it is time that gas prices move down. Our trading partners must understand this. Oil exporting nations plainly do. It is time to tell all gas exporting nations that U.S. companies and U.S. consumers will not tolerate unrealistic prices for gas imports much longer.

To emphasize the urgency behind the need to see gas prices renegotiated in short order, I have introduced along with Senators Dixon, Johnston, Boschwitz, Kassebaum, Danforth, Burdick, Jepsen, Levin and Pressler, a resolution calling on the Secretary of State, with assistance from the Secretary of Energy, immediately to enter discussions with nations presently exporting natural gas to the United States, and to report back to the Congress on the progress of these discussions within 30 days. This resolution is addressed to all of our gas imports -- from Canada and Mexico as well as Algeria. Our government has already begun these conversations with the Canadians, but not with the sense of urgency I would like to see.

Canada has always been America's closest trading partner, and I have no doubt that the import by the United States of Canadian gas can continue to be mutually beneficial. I recognize, for instance, Mr. Chairman -- and you can see on this map -- that Idaho receives a great deal of Canadian gas. The Canadians have been a secure supplier of gas to both of our states. But to keep this trading relationship fair, to keep it of mutual benefit, the gas should be priced at fair-market levels. I think the Canadians are becoming more and more concerned about preserving future markets, and they are beginning to recognize that prices are too high.

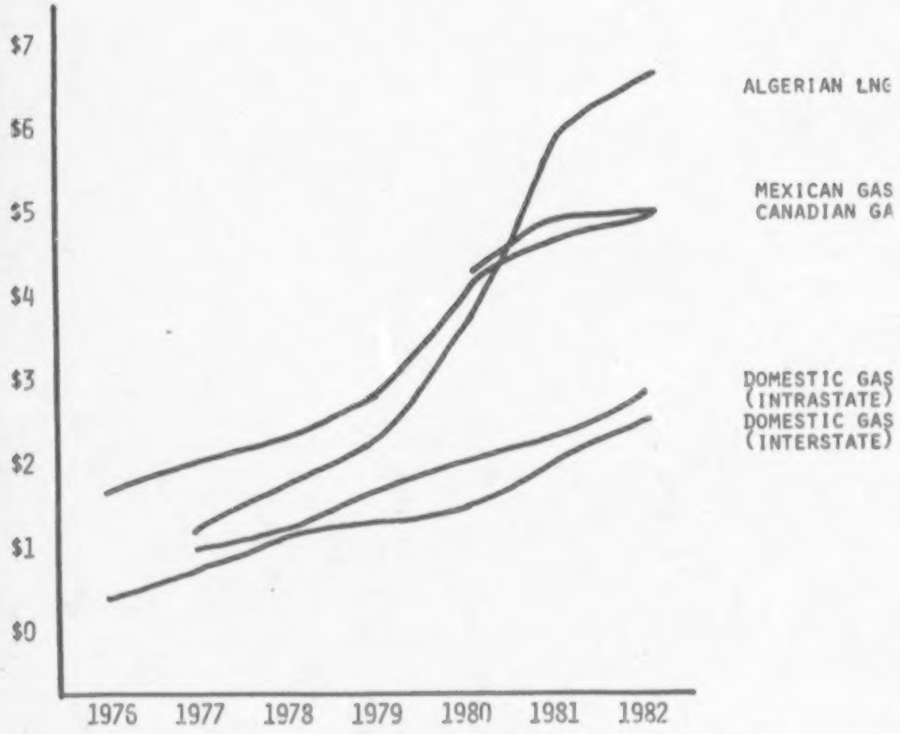
The bill before your Committee does not extend to the Canadian and Mexican situation. As I stated earlier, the bill was introduced specifically to address exorbitant LNG prices. Senator Dixon and I originally introduced it in the fall. Since then, we have seen very little progress in renegotiating a lower price or a lower take requirement with the Algerians. I remain hopeful that regulatory relief will be forthcoming, and I would still prefer that solution to this or any other legislative strategy. But every day we wait, consumers in Illinois and elsewhere in the Midwest are paying for this LNG, and workers are losing their jobs as a direct result of this high-priced LNG.

We cannot afford to wait any longer. I seek the Committee's support in addressing this issue as fast as possible. I ask that our bill -- or a version of it -- be included in a final domestic natural gas package, if one is adopted by the Committee. At the same time, I believe the issue -- and the bill -- can and should be pursued administratively as urgently as possible, no matter what action your Committee takes on the Administration's proposal for domestic gas. One way or another, we must solve this problem quickly.

If between now and the passage of this bill, individual parties or the regulatory agencies have worked out a solution, so much the better -- and I will withdraw the bill. Otherwise, I believe Congress has the responsibility to bring down high LNG prices for the benefit of gas consumers everywhere.

DOMESTIC VS IMPORTED GAS PRICES

(U.S. $ PER MILLION BTU)



DATA SHOWN ARE AVERAGE PIPELINE ACQUISITION PRICES

SOURCE: DATA RESOURCES, INC.

DOMESTIC VS IMPORTED GAS PRICES

(U.S. $ PER MILLION BTU)

	1976	1977	1978	1979	1980	1981	1982
DOMESTIC (INTERSTATE GAS)	.43	.63	.82	1.20	1.48	2.06	2.50
DOMESTIC (INTRASTATE GAS)	-	.79	.91	1.50	2.04	2.26	2.82
CANADIAN GAS	1.64	1.95	2.15	2.56	4.23	4.73	4.92
MEXICAN GAS	-	-	-	-	4.32	4.91	4.92
ALGERIAN LNG	-	1.05	1.50	1.99	3.70	5.94	6.56

DATA SHOWN ARE AVERAGE PIPELINE ACQUISITION PRICES

SOURCE: DATA RESOURCES, INC.

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Alice M. Rivlin
Director

February 25, 1983

Honorable Charles H. Percy
Chairman
Subcommittee on Energy, Nuclear
Proliferation and Government Processes
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is in response to your inquiry of February 17, 1983, regarding imports of liquified natural gas from Algeria and pipeline gas from Canada and Mexico. These imports are currently priced well above many domestic sources of natural gas that are not being brought to market, thus raising the issue of whether the public interest would be served if this situation were to continue for the long run.

In general, there is no economic rationale for continuing to pay prices that are above the competitive level. If there is an energy policy rationale, it must rest with energy security--the need to build stable and diverse sources of energy supplies that can be guaranteed during future oil disruptions. Such a rationale is questionable for two reasons. First, the goodwill generated by such purchases may be fleeting, and there is no way to evaluate how strongly it would influence foreign actions during an energy crisis. This may be particularly true in the case of Algeria, if the source of a future disruption lies in deliberate OPEC action. Second, even if goodwill could be counted upon to yield additional natural gas during a future oil supply disruption, it is unclear whether this would be a cost-effective investment. Other investment options, such as oil for the Strategic Petroleum Reserve, could well be superior and would certainly increase the degree of control that the U.S. government could exercise in an oil emergency.

If I can be of further assistance to you in this matter, please contact me.

With best wishes.

Sincerely,

James Blum

for Alice M. Rivlin
Director

The CHAIRMAN. Thank you, Senator Percy.

You do address a problem that is a matter of concern to a great many, although I think we need to put part of that problem into a different context, and that is the historical context, the fact that many contracts, whether it be for domestic or imported supplies, were entered into at a time when there was an actual or perceived shortage of supply.

It is easy to say we should not sign the high priced contracts at a time when we have a surplus; not so easy to say to consumers who were then having their supplies curtailed that you should not pay the price in order to get the product.

I would also remember that Secretary Schlesinger, then the head of the Department of Energy, was very greatly criticized for delaying the purchase of Mexican gas, but the reason he did it was he was trying to rationalize controlling the price paid to domestic producers and at the same time he was willing to pay more to foreign producers.

That historic context needs to be continued, I believe. It still does not make much sense to pay domestic producers less than foreign producers, and yet we are considering legislation in which there will be continued price regulation on domestic producers.

It is fine to say we will not pay you, we will not take your supply, at a time when we have that leverage in the marketplace. This is the time we ought to be talking to our friends in Canada, Mexico, and Algeria and elsewhere, that indeed, we will not take your supply, but there may be another day coming in which they will remind us of that earlier discussion.

Senator PERCY. As I have said, I am looking to the long term relationship and you cannot have oil prices coming down as rapidly as they are, you cannot have plants closing down, unemployment, converting over to other forms of energy and continue that long term relationship.

There are excuses in the short term, if you have to pay premium prices in times of a shortage, but when we have a continuing longer period of time ahead of us, when there is going to be excess supply of gas domestically, we cannot continue forever to pay premium prices from abroad and have a long term relationship.

The CHAIRMAN. What is your estimate of how long the excess supply of natural gas will exist in this country?

Senator PERCY. I think that to an extent depends upon the way you untangle the present regulatory jungle we are in on gas prices.

There has to be incentive for production. Today there is more incentive than there was before and that is why we have a lot of domestic gas but we also have excess capacity because of lower economic activity. We have to take that into account.

I would say for quite some time ahead, it appears as though there is going to be adequate domestic sources of supply and for that reason, I urge our friends abroad and our pipeline companies here to renegotiate these prices because they simply are uneconomic and unrealistic in the present market.

The CHAIRMAN. You spoke of long-term policy, and in response to my question you said for a long time we will have excess supply or at least a more than adequate supply of natural gas.

Would you relate those in some kind of a rough estimate of time?

Senator **Percy**. I would say this year, next year, and certainly I am looking to the fact that next year, unless we do this, we are still going to have excess domestic supply and we would still be paying a premium and I am going to still find plants that are closing because they cannot pay, their margins are so thin, they cannot pay these prices.

Now energy costs are a very, very big bite of the cost of a university, of a hospital, of a factory.

The **Chairman**. If I understand you then, you are saying the supply/demand balance that we now enjoy, which indicates we have more supply for natural gas than we have demand for it in the marketplace, will exist at least for the next 1 or 2 years.

Senator **Percy**. Absolutely; I think we will be sitting here next year no matter how bitter cold it is, I still think we will be having excess supply.

The **Chairman**. Would you care to speculate about whether that is true 10 years from now?

Senator **Percy**. Sometimes we do not know what the Senate is going to do this afternoon much less tomorrow. I am not quite sure what would be happening 10 years from now, no; I could not anticipate that.

The **Chairman**. In spite of all of our efforts, the Senate does not supply all the natural gas.

Senator **Percy**. We supply a lot of the hot air though.

The **Chairman**. Senator Ford.

Senator **Ford**. Senator Percy, I can understand your concern about foreign supply of natural gas. You referred to Algeria and Canada in your statement and those upper tier States do secure a fairly good percentage of their natural gas supply from our Canadian neighbors.

They may look at our long-term problems closer than we do, referring to the Canadians. It is my understanding that the Government has informed their producers to make the best contract with us they can on the basis that we will be short again in 1986.

Now we are sitting here trying to do something today, that gets us back in the same old problem. We never estimated in 1977 and when you supported this legislation, that we would have the economic turndown that we did. Now we have an economic turndown and we are rushing in here blaming everybody but ourselves.

We did not have 20/20 foresight. Some of our neighbors are having some interest in our long-term future, maybe more than we are.

If you say we are going to have a sufficient supply for the next 24 months, what are we going to do in the next 36 months or the next 48 months? Are your people going to be laid off because we have a shortage again and we will be rushing back in and saying, get on the producers, get on the pipelines.

Do you have any long-term solution to this? Just deregulate and let it happen?

Senator **Percy**. Senator Ford, if you had in your State the situation where we are paying twice as much for natural gas from Canada, when we are purchasing in the United States 40 percent of our supply, we are a big customer for Canada. They are charging us twice as much in Springfield, at our gate there, as they charge in Toronto, when Springfield is closer to the field than Toronto is. That is just exorbitant.

Senatory **Ford**. I understand that and I understand what you are saying, but you are trying to get a short-term fix.

In 1977 we had a shortage. You would take it from anybody you could get it from then to keep your people at work. Now that contract that was signed, you want to say let's abrogate that contract and reduce the prices. You are chairman of the Foreign Relations Committee, I would say that this gets into international relations pretty hard.

Are you saying to us as chairman of that committee that these international problems are something that we have to put on the back burner and we just take care of the contracts and deal with those?

Senator **Percy**. No, I am not saying that at all and we are not abrogating it one bit. We are adhering to them, at the expense of losing employment and at the expense of having some plants close. We are adhering to them now.

All we are saying is let's sit down and talk about this. I have sat in my office with the producers. I have sat there with the ministers from Canada, from Toronto, and talked about this, if we are going to be a long-term customer, if I am not going to have plants shutting to convert over to other forms of fuel, if we are going to continue to buy 40 percent of Canadian gas, we cannot do so by going through this year and next year at these prices.

We are going to find that we are not going to be that good of a purchaser. I would like to see that long term relationship continued because I think it is desirous for us to have a long-term continuing relationship with these three countries, but it cannot be done under these economic conditions.

Senator **Ford**. Senator, can we by law set that long term diplomatic relationship with those countries?

Senator **Percy**. Well, I would much prefer rather than putting it in the concrete of law, to urge, and that is why the resolution that we have introduced with so many of our colleagues as cosponsors, falls upon the Secretary of State to urge negotiations.

I would much rather it be done by the private sector. I have met with the heads of the pipeline companies and have said, we will stand behind you in urging a renegotiation. They would like to see a renegotiation. They like to see the sense of urgency we are putting behind this, because they are going to lose customers.

Senator **Ford**. As a businessman, I would like for you to help me get my prices down so I could sell my product.

Senator **Percy**. You are in Illinois. I would not mind helping you as a businessman. I would help any Illinois businessman.

Senator **Ford**. We are trying to take care of the country, Senator, and we are trying to take care of over 200 million people and each of us have isolated cases.

We are a consuming State. I can stand there and put my hand on the greatest resource in the world, coal, but we cannot burn it. The environmental restrictions prevent us from doing that. Yet we find now when everybody is fussing about the high prices, that we are not making any effort to find new sources of energy from the resources we now have.

Everybody is backing off. They turned the spigot off. Turned the spigot off on our own resources and complain about foreign sources. If we had our domestic resources, we would not care whether we had any foreign sources or not. We would be energy independent, yet we are fussing about everything and trying not to fix up our house. The roof is leaking and no one really wants to get to it.

It is a little bit frustrating to me. Everybody coming here going in 10 different ways, but this committee in its judgment has to give you a comprehensive program that you will not like when it comes out.

Senator PERCY. I am just asking that as a part of this comprehensive program, this committee also put its immense influence behind the suggestion that we should renegotiate these contracts.

We have never hesitated to renegotiate the price upward, when we had to pay more and we have been paying steadily more at a time when economic recovery is so dependent upon many factors including cost of production.

Also, we have to take into account that in Illinois, 65 percent of our homes are heated by natural gas. I have people shaking their bills in my face. Why are we paying much more this year as we were last year when it is a milder winter, we are still paying more for gas. They cannot understand it. These are low-income people, a lot of elderly people.

Certainly Senator Heinz understands that problem heading the Aging Committee.

They just cannot understand why inflation is going down on virtually every single item, prices are coming down and oil is coming down and natural gas is going up and part of it is because of the very high cost of imported—we buy 15 percent of all LNG imported from Algeria in Illinois.

We would just simply like to see those prices negotiated down to a more realistic level.

Senator FORD. Are you for basic statute changes to encourage increased use of coal?

Senator PERCY. We share it with you. We are a coal producing State. I have spent a lot of my time figuring out ways we could use more coal and still meet environmental standards. I would like to convert to coal as much as we can. I think it is in our interest to do so.

We have a 500 year supply of coal and we have to find the technology that will enable us to do that. We have been working together on that project for many, many years.

Senator FORD. Thank you, Mr. Chairman.

The CHAIRMAN. I might just say for the record, if I understand your suggestion correctly, you believe that we ought to in some way try to effect negotiations with the supplier nations.

Senator PERCY. Yes.

The CHAIRMAN. If I understand further, you are not suggesting that is something that we can do unilaterally by statute. Am I correct?

Senator PERCY. No; I think we actually can. What I have said is I hope that the resolution we put in, the spirit of that, to speed up these negotiations, now is the time to do it so let's be certain that we do not have to face next winter paying three times the price for a large part of our imported gas as we have as domestic supplies, but if we have to, then we have the authority, we have the ability to do it by statute and relate it to say a comparable price of oil.

The CHAIRMAN. Is it your suggestion that if negotiations fail, that we should do so, erect a statutory standard for the price of imported supplies?

Senator PERCY. That is the suggestion in the legislation that is now before this committee that I have introduced that is cosponsored by 8 or 10 of my colleagues.

I hope we do not have to use that authority. I hope we would do it voluntarily. Just like arms control negotiations, they are never going to get to the negotiating table unless they feel that there may be another resort, a poorer way to do it. I think it is essential if we are going to help our economy and help these beleaguered consumers who are asking for assistance.

The CHAIRMAN. Before departing from the subject completely, and I want to yield to my colleagues for whatever comments they may have, the record should note, I believe, the efforts that many of us on this committee have already undertaken in past months and years, to negotiate with our friends in foreign countries on this very subject.

You mentioned having talked with them in your office. I have talked to them in their offices in Toronto and Ottawa and in Calgary. I have talked to them in several meetings in Canada as well as several meetings in the United States, urging them in much the same way that you have, pointing out what they know is a fact, that they are losing market in the United States already and that it ought to be to their interest to reduce the price in order to regain that market.

I would say so far that has been singularly unsuccessful.

I think the immense weight and prestige of the Foreign Relations Committee might be needed here as well, since you mentioned the immense influence this committee has, let's add yours to it.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. Just one question, Senator Percy.

Our Government has been repeatedly accused of inconsistency and unreliability in its foreign energy commitments. As chairman of the Foreign Relations Committee, what is your assessment of the foreign policy fallout from the enactment of a bill—I can't use those legal terms either—getting rid of foreign gas contracts?

Senator PERCY. Let me speak first from the perspective of a quarter of a century in industry. I have always lived up to the letter of every single contract but frequently companies with whom I have contracts, whether domestic or abroad, or occasionally I have taken the initiative to go back and say, look, in the light of perspective now, 2 years later in the practical world we are living in, this particular aspect of the contract is now detrimental to our mutual interests, let's sit down and talk about it. We have generally always renegotiated when it was our mutual interest to do so.

We are asking you to do the same thing in this case. We have done it by first going to them. I really commend the chairman for the initiative of going up there and actually sitting down on their home territory. I have been in Alberta, too. I have talked also up there but not with the perspective that you did and not with the sense of urgency that I now have about it.

I do see our relationship with Canada, Mexico, and Algeria impaired in the long run if we do not take care of it. No one will ever forget the prices they are now paying and the crunch they are in, in the worse recession we have had in 40 years and it is hurting. It is hurting badly and it will hurt our relationships if they feel the prices are literally unfair.

No one has given me any real justification for charging us twice as much for exactly the same gas as they sell in Toronto. There is not a justification they can provide other than they happened to get a contract from us at a particular time when it appeared feasible.

In the light of the present conditions—if oil prices were skyrocketing, for instance, at this time, we would probably just have to grin and bear it. When alternate sources of fuel that could be switched over to are there, I think the natural gas producer ought to take a look, do I really want to be a realistic pricer in this kind of a market or just hang in there and soak them and then see the resentment that is going to be there and the conversion to other forms of energy?

Senator HECHT. Thank you very much. No further questions, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Heinz?

Senator Heinz. No questions, Mr. Chairman.

The CHAIRMAN. Senator Nickles?

Senator NICKLES. Thank you, Mr. Chairman.

Senator Percy, I appreciate your comments. I have been working a little bit and I do not know that I know the solutions on how to handle some of the problems that we have in high import gas and LNG.

I might let you be aware that we have looked into the situation in Canada and the $4.94 price that you mentioned. We find that about $1.42 or about 30 percent of that is tax which is going to the Canadian Government.

We also looked at the Mexican price and that is also about $4.94, in that ball park, which is 100-percent owned by the Mexican Government.

We find resources in the distribution system, et cetera. We are paying that kind of price. Does it seem absurd to you that we would pay those prices to those countries and to those governments and yet have price controls for gas at substantially less for domestic production?

Senator PERCY. It really does.

Senator NICKLES. Are we not, in effect, by having those price controls on domestic production—in some cases right now, the present price is as low as say 30 cents in some cases. We pay our domestic people 30 cents and in turn we would be paying to the Mexican Government $4.94 for the same thousand cubic feet of gas.

Senator PERCY. I think it is an anomaly and this is why I am glad that this committee is going to give the time and attention it is going to, to the proposals made by the administration.

I am really not wise enough to know what impact it is going to have. I do know that energy costs are a very important part of all industry costs and for some industries they are a controlling cost as to whether the industry can succeed, whether they can compete effectively or not.

I did come to the conclusion after a lot of study on the oil position that we should decontrol. I took that position strong and hard. Our Government Affairs Committee had created the Department of Energy. I sat down with Jim Schlesinger, the Alliance to Save Energy that had its annual board meeting here yesterday, Fred Hartley, other leaders in the industry were with us.

We fought for 3 hours in our board room in the meetings we had here on decontrol of oil and finally decided as long as there was a payback to low-income families, and I know Senator Heinz is very sympathetic with this, and elderly people, as long as we had that, we wanted to go for decontrol. That decision was absolutely right.

It has given us the oil glut we have. It has provided a mechanism for weakening the strangle hold that OPEC had on it. We did right in that case.

I do not know enough of the facts in the gas case yet and that is why we will all watch very, very carefully your hearings, your deliberations, to see what is the right course in that regard.

Senator NICKLES. Your proposal which is calling for a price limitation on imports, the administration is calling for total decontrol by January 1, 1986. Do you think maybe it would make sense to possibly have controls on imports while at the same time we are having domestic controls, to lift those controls simultaneously?

Senator PERCY. I would tend to think if you did have a totally free market, you probably then would not need any—you would just let the marketplace set the price and you would not need these long-term contracts. Probably you had to go into these long contracts because of the extraordinarily complex way we have tried to control gas prices.

Senator NICKLES. I would very much concur with that.

If you look at Canadian gas or if you look at Mexican gas or if you look at the LNG, whatever, you will find that we actually have production fairly close to Alberta. We have some production very close to some of the Mexican gas and you would find while we have been holding our domestic prices very, very low, we turn around and are writing these tremendous checks to the other governments for the same exact commodity and it seems to be a very foolish and very expensive energy policy which has actually been the case under our present NGPA.

We have actually encouraged the outflow of dollars. We have actually encouraged under our present NGPA high priced LNG.

I think we could solve a lot of that the more rapidly we move to totally deregulate a market and then I do not think we would need the controls you have advocated on the imports.

Thank you very much.

Senator PERCY. It could well be. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Percy. We appreciate your testimony this morning. We will appreciate your continued work on the foreign relations aspects as well.

We now turn to the panels. I would remind both the panelists and the members of the committee that there are three panels, some 13 witnesses yet to be heard. I do not mean to unduly restrict that portion of the hearings. We have gone now almost 2 hours. We have gotten through three witnesses. We have 13 to go and mathematics tells me we will be finished sometime Sunday night.

Senator FORD. Never on Sunday, Mr. Chairman.

The CHAIRMAN. I am going to try to ask each of the witnesses to comply with the suggestions that we have made in the past that they place their written statements in the record and they summarize in not more than 5 minutes the testimony they will present to us, and we will operate under a 10-minute time rule with respect to the questioning of those witnesses.

We will now call the first panel, Mr. Nick J. Bush, president, Natural Gas Supply Association; Mr. Kye Trout, Jr., chairman of the Board of the Independent Petroleum Association of America; and the Domestic Petroleum Council represented by Mr. Perry O. Barber, Jr.

Gentlemen, none of you is unfamiliar to this panel or to the people that are here. We welcome you back again before this committee.

Mr. Bush, if you would please present your testimony.

STATEMENT OF NICHOLAS J. BUSH, PRESIDENT, NATURAL GAS SUPPLY ASSOCIATION

Mr. BUSH. Mr. Chairman, members of the committee, good morning. My name is Nicholas J. Bush, I am president of the Natural Gas Supply Association, an organization that represents domestic producers who market about 90 percent of the Nation's natural gas.

In keeping with your objective to keep the presentations brief, I would ask, Mr. Chairman, that my complete statement be entered into the record and I will summarize my remarks.

My statements this morning, Mr. Chairman, oral and filed, will not repeat our previous extensive testimony on a wide variety of issues facing the natural gas industry including the question of proper handling of contractual questions. I would ask that the members of the committee and their staff refer to our filed statements in December for more complete details of our views on these issues.

This morning, Mr. Chairman, I would like to make six points.

First, the natural gas issue demands a comprehensive solution. The quick fix piecemeal approaches introduced in the postelection session were wisely rejected and should be rejected once again in this session.

We oppose bills already introduced such as S. 689 and those contemplated by Senators Eagleton, Danforth, and Kassebaum that would seek to maintain controls on large volumes of natural gas and simply take one more guess at the proper way to refine the regulatory handling of the remaining volumes.

Ironically, Senator Heinz may have said it best in his remarks in introducing S. 689 when he wrote "We enacted NGPA in 1978 pursuant to the best wisdom and political climate prevailing at that time. Since 1978, however, a series of conditions have arisen which we could not have anticipated then.

We agree and unfortunately the same is true today. No legislation based on permanent controls with new regulatory schemes could possibly anticipate what the Nation or the world's energy or economic conditions will be in the near, mid- or long-term.

Such legislation offers the false promise of short-term relief but in fact delivers only serious long-term ills.

I might note at this point, Senator McClure, that I was fascinated at the comments made by three witnesses today and one Senator on the committee, detailing the anguish being felt by many industrial consumers of natural gas.

Senator Specter identified the perils of the steel industry and I think Senator Heinz chipped in on that fact and Senator Percy also spoke as Governor Orr did about the fact of processed gas consumers in Indiana.

I think it is worthy to note to the committee that the American Iron and Steel Institute as well as the processed gas consumers, as well as 30 other major industrial consumer organizations strongly support the total decontrol of all gas.

There is no one more sensitive to price and supply implications, I would submit to you, than the largest consumer of natural gas, the industrial sector.

Second of all, we endorse President Reagan's and Secretary Hodel's efforts to achieve a competitive market for all natural gas. We will support their efforts to establish sound natural gas policy.

Third, in reviewing S. 615 and it's House equivalent, H.R. 1760, we believe there are two principal changes that need to be made to the legislation to facilitate reaching these objectives.

With regard to the gas cap, it is essential that it be as reflective as possible of actual market conditions, if it is to serve as a market surrogate. We believe for it to be a pure reflection of actual market conditions as possible, the prices paid for natural gas under any renegotiated contract should not be included.

Fourth, the proposed limitation on a pipeline's ability to passthrough its purchased gas cost as drafted in the legislation needs to be more flexible. Otherwise, it may inadvertently prevent pipelines and producers from renegotiating contracts. We believe the legislation should permit the automatic passthrough of increases due to prices paid for gas under new and renegotiated domestic contracts so long as the pipeline's average of new and renegotiated contract prices does not exceed the gas cap.

The bill should allow as well the traditional feature of FERC regulations that permits pipelines to collect filed rates above the allowed rate, subject to refund in the event these rates are later disallowed in full or in part by the FERC.

Fifth, the date set out in the legislation as introduced must be retained. The removal of all regulations from natural gas at the wellhead by January 1, 1986 is an extension of both direct and indirect controls beyond dates in the existing law.

Further slippage could have severe supply impact in the near and intermediate terms.

Six, and finally, the deregulation of forever regulated gas under the President's proposal is absolutely critical to the success of this legislation. All gas must be allowed to reach market levels, to achieve the goal of a contract driven transition to an undistorted deregulated wellhead market after January 1, 1986.

A competitive market for all gas prevents premature abandonment of mature gas properties and provides consumers with additional supplies of gas at reasonable prices.

The deregulation of all gas is the only way to remove the serious market disorder problems that have been caused by the Natural Gas Policy Act.

I might just note in closing, Senator, it is absolutely bewildering for me at least to hear statements saying that we cannot deregulate all gas until we remove the disorders and inequities from the market. It is precisely because of the large volume of forever regulated gas that the inequities and disorders exist.

[The prepared statement of Mr. Bush follows:]

STATEMENT OF NICHOLAS J. BUSH, PRESIDENT, NATURAL GAS SUPPLY ASSOCIATION

Mr. Chairman and Members of the Committee, I am Nicholas J. Bush, President of the Natural Gas Supply Association, an organization of natural gas producers who explore for and produce about 90% of the nation's natural gas.

The Association thanks the Chairman and the Committee for affording us the opportunity to participate in these important hearings, which will examine current natural gas policy and changes in present law which were recently proposed by the Reagan Administration.

The Association has recently appeared before several Congressional panels examining various aspects of the natural gas issue.

On September 20 of last year we appeared before the Subcommittee on Fossil and Synthetic Fuels of the House Energy and Commerce Committee. Our comprehensive testimony at that time examined the impact of the Natural Gas Policy Act upon natural gas markets and the gas industry, and explained the continued importance to our gas delivery system of contractual mechanisms such as take-or-pay and indefinite price clauses. That testimony also reviewed substantial evidence of disorder in natural gas markets, induced in large part by NGPA, and concluded that the NGPA should be replaced by legislation providing a phased transition to a deregulated natural gas market at the wellhead.

On December 13 of last year the Association appeared before this Committee to discuss the state of natural gas markets and the folly of enacting short-term emergency gas legislation in the closing days of the last Congress. At that time we explained that short-term, piecemeal responses to our natural gas problems would lead to serious long-term supply and price consequences, with adverse impact upon natural gas consumers. We urged the Committee to reject piecemeal proposals in favor of a comprehensive, market-oriented approach to natural gas policy which could be considered and implemented during the first session of the 98th Congress. We also filed with the Committee detailed position papers discussing the positive functions of take-or-pay and indefinite price clauses in natural gas contracts.

On February 7 of this year we appeared at a field hearing of the Joint Economic Committee in Davenport, Iowa, which also examined various aspects of the natural gas issue.

Our earlier testimonies thoroughly discussed several facets of the natural gas issue which we will not address again today, due to time constraints. However, we ask members of the Committee to refer to our earlier remarks for a full statement of the Association's thinking on all aspects of the natural gas issue facing the country.

The Natural Gas Supply Association (NGSA) has consistently advocated the wellhead deregulation of all natural gas at the earliest possible date. We also oppose any "windfall" or excise tax upon gas freed from price controls. In addition, NGSA supports equal access for all buyers to natural gas from any and all sources, onshore and offshore, and urges removal of all end-use restrictions on natural gas, including the repeal of the incremental pricing provisions of title II of the NGPA. The Association has urged the Congress to replace the NGPA with comprehensive new legislation containing these elements, and we encouraged the Administration to come forth with an appropriate plan to accomplish these objectives.

On February 26, 1983 President Reagan announced in his weekly radio broadcast that he would forward to the Congress a proposal making extensive revisions in current natural gas policy. The Administration proposal has now been introduced in the Senate and House of Representatives as S.615 and H.R. 1760, respectively.

The stated goals of the legislation are: to correct deficiencies in the Natural Gas Policy Act of 1978, to protect natural gas consumers from unnecessary price increases during the transition period due to current distortions in the regulated market for natural gas, to permit natural gas contracts to reflect the change from a regulated to a free market, to eliminate incremental pricing requirements for natural gas, to eliminate certain fuel use restrictions, and to provide all buyers equal access to natural gas supplies.

These goals would be accomplished by: (1) establishing a cap mechanism on prices received by producers, which could roll back some prices and preclude any increases in excess of market levels; (2) imposing a FERC review on the passthrough of interstate pipeline purchased gas adjustments above pre-enactment level, with an inflation adjustment; (3) deregulating all natural gas not later than January 1, 1986; (4) allowing renegotiation of current gas contracts after the date of enactment to facilitate the transition to a deregulated gas market; (5) providing buyers and sellers of gas under pre-enactment contracts not renegotiated prior to 1/1/1985 a right to market-out of such contracts; (6) restricting the operation of take-or-pay and price escalator clauses in current contracts until January 1, 1986; (7) repealing certain sections of NGPA and the Fuels Use Act; and (8) providing expanded access to gas supplies now captive to the interstate market.

We commend President Reagan and Secretary of Energy Donald Hodel for their efforts to eliminate the market distortions and inequities created by the NGPA, and to establish a sound, balanced and rational natural gas policy.

The Association supports the Administration's goal of achieving a totally deregulated natural gas wellhead market. We are pleased that the Administration has come forward with comprehensive legislation to serve as a focus and legislative vehicle for those who believe, as we do, that a return to market-determined wellhead pricing best serves the interests of the nation's natural gas consumers. The deregulated natural gas market contemplated by the Administration promises adequate natural gas supplies at reasonable prices to consumers, without regional distortions which have been the hallmark of NGPA, and without gas curtailments experienced under Natural Gas Act price regulation. A totally deregulated market for gas in the field would be, without doubt, the most salutary result of enactment of the Administration's proposal.

Other aspects of this legislation aim to protect consumers against increases in natural gas prices during the transition to a deregulated wellhead market. This goal would be achieved through an administrative review of passthrough of increased purchased gas costs by interstate pipelines; basically, these costs would be held to the immediate pre-enactment level, plus an inflation allowance. Purchased gas costs in excess of this amount could be recovered only through FERC review in a special proceeding.

NGSA recognizes the need to protect gas consumers against any unnecessary costs as we complete our transition to an efficient, deregulated natural gas market at the wellhead. According to many experts, a phased deregulation would save gas consumers money compared to what they would pay if NGPA ran its course. We have argued, convincingly we think, that current law encourages wasteful and uneconomic purchases of gas. Evidence of this fact abounds and is well-known to the Members of this Committee.

In addition to the safeguards of the free market, the Administration's proposal contains two additional consumer protection elements: the gas cap mechanism and limitation on passthrough of pipeline purchase costs. Some observers of the natural gas market believe that the gas cap mechanism in the President's proposal may lead to reduced prices for gas in NGPA categories 102, 105, 108, and possibly, 103; gas covered by these categories is about 50% of current supply. The cap mechanism will also limit the operation of price escalator clauses until January 1, 1986. The loss of revenue from these sources will be significant, but at least arguably market-related.

On the other hand, an extension of the passthrough limitation into an inflexible, time-consuming regulatory proceeding could eliminate the benefits consumers would otherwise receive from the decontrol component of the program. The limitation needs to be carefully drawn to complement the transition to market pricing. Any further, artificial restraints on prices during the transition period will only distort market signals which must be sent and received in order for the proposal to achieve its goal of an orderly deregulated wellhead market after January 1, 1986.

As currently drafted, S.615 and H.R. 1760 contain language which may hinder, rather than facilitate, the Administration's and the sponsors' objective of a contract-driven and largely non-regulatory transition to a deregulated market. Accordingly, NGSA advocates certain changes which are totally in keeping with the overall framework and goals of the Administration's proposal:

1. **The Gas Cap**: The so-called "gas cap" as written into the Administration's legislation may inadvertently thwart the objective of significant voluntary contract negotiation. The cap is intended to serve as a market "surrogate" or indicator during the transition period, signalling to natural gas buyers and sellers the market price of gas at any time between the date of enactment and January 1, 1986. Given this intent, it is important that the gas cap be as reflective as possible of actual market conditions, and that factors which will tend to distort the cap as an index of the market be removed. Of course, the continued existence of a significant volume of regulated gas during the transition period will complicate the objective, as will the process of renegotiating existing contracts which were negotiated under the Natural Gas Act and NGPA.

Still, insofar as is possible, the gas cap should be a "pure" reflection of actual market conditions.

The inclusion of prices paid for natural gas under any renegotiated contract does not conform with this objective. Renegotiated contract prices might frequently not be reflective of arm's length transactions, because they are arrived at within the context and framework of the pre-existing contract. For example, a gas producer with a 104 or 105 contract may be able to negotiate with his buyer to increase the price in graduated increments in return for additional consideration to the buyer. This will give the producer some relief from the earlier contract price and prevent premature abandonment, but the renegotiated price may still be far below market value. The graduated increments do not reflect the value of the gas package in the free market, and would distort the gas cap if included within it.

Likewise, producers could agree to renegotiate downward certain relatively high price gas, from, say, $7.00 to $5.00. In such a case the final renegotiated price would remain above market. The resulting renegotiated price would also be unreflective of new gas market conditions, and similarly should not be included in contract prices used to make-up the cap.

The inclusion of all contract renegotiations in the gas cap could have other perverse results. Suppose that a purchaser and seller want to make a minor and technical change to a current contract: changing the gas delivery point or adding a well. The cap as currently drafted could discourage the making of such minor adjustments, because the contract would then be "amended" and its price included in the gas cap. The danger of distorting the gas cap by including prices in such renegotiated contracts far outweighs any benefit obtained from their inclusion.

Clearly, prices paid in contracts for the sale of new natural gas, including imports, LNG and synthetics, and prices paid for gas in successor contracts to expired contracts provide a more trustworthy approximation of gas prices under market conditions during the transition period. Accordingly, the cap needs to be restricted to these market-determined contracts.

2. **The Passthrough Limitation:** The proposed limitation on a pipeline's ability to pass through its purchased gas costs following enactment of the Administration's legislation should be more

flexible. As drafted, it may impede the ability of producers and pipelines to renegotiate contracts. Low-priced gas supplies are not spread evenly among the pipelines. Those with large proportions of old gas in their supply will face extreme problems in operating within the passthrough limitation. An inflexible passthrough limitation would preclude these pipelines from undertaking the contract renegotiations necessary for the success of the bill. Injecting further uncertainty and delay into this area through lengthy administrative procedures would also risk frustration of the contract renegotiation process.

A pipeline's average gas purchase cost could increase due to several causes; an important factor is the depletion of low-priced old gas supplies and their replacement with more costly new supplies. On an average, 10% of the nation's gas supply is depleted and must be replaced each year; however, the amount of decline varies considerably from pipeline to pipeline. Based on an EIA study of recent experience, natural depletion has caused prices to increase at a 4% rate above inflation. The President's proposal, as drafted, makes no allowance for this natural phenomenon, which is outside the control of the parties.

We believe the proposal needs to be amended to permit automatic passthrough of increases due to prices paid for gas under new and renegotiated domestic contracts, so long as the pipeline's average of new and renegotiated contract prices does not exceed the gas cap. The passthrough limitation needs to adjust to changing market conditions if it is to facilitate the transition to market pricing and enable parties to renegotiate existing contracts. Automatic passthrough of new and renegotiated contract prices up to the cap will improve the operation of the limitation concept. If supplies are abundant the cap price will remain low; but if demand exceeds supply gas prices will be able to adjust upward, balancing supply and demand and easing the transition to market pricing of all gas on January 1, 1986. Of course, if individual pipelines enter contracts well above those typical of average pipeline behavior, explicit authority for passthrough will be required.

We also believe that the bill should allow the traditional feature of FERC regulation that permits pipelines to collect filed rates above the "allowed rate", subject to refund in the event those rates are later disallowed in whole or in part by the FERC. This will enable the regulated entity to enter into new and renegotiated contracts, and fully protects consumers through the availability of refund if FERC, on review, disallows passthrough of these costs. The absence of this mechanism could prevent pipelines from entering into any contract, new or renegotiated, if a pipeline believes these costs might not be recovered.

We further note the absence of well-defined standards and guidelines for FERC review of pipeline costs in excess of the passthrough limit. A clear statement of these standards will determine how the FERC review requirement will operate. Flexible standards would permit the flow-through of costs which result from the proposal's contract-driven solution to our natural gas pricing problems.

3. **The Deregulation Date:** A third consideration we would impress upon the Committee is the need to adhere to the dates set-out in the legislation as introduced. The bill now schedules the removal of all regulations from natural gas by January 1, 1986. This is an extension of both direct and indirect controls beyond dates in existing law. Further slippage beyond these dates might have severe supply impact in the near and intermediate term, and would be contrary to the interests of

consumers. Accordingly, any further extension of these dates is unacceptable.

The deregulation of forever-regulated gas under the President's proposal is critical to the success of this legislation. All gas must be allowed to reach market level under the proposal to achieve the goal of a contract-driven transition to an undistorted, deregulated wellhead market after January 1, 1986. A competitive market for all gas will prevent premature abandonment of mature gas properties, and provide consumers with additional supplies of gas at reasonable prices.

The record established by oversight hearings before the House and Senate energy committees and before the FERC demonstrates that price controls on natural gas are the cause of considerable disarray in natural gas markets. Because of the vastly uneven distribution of forever-regulated gas among interstate pipelines, some enjoy significant long-term advantages over others in obtaining new supplies.

Market shares among competing manufacturers are shifting due to some having access to cheaper supplies of natural gas. This same disorder is also distorting inter-fuel competition. No region of the country is spared. By ending controls on all gas prices the President's proposal will end discrimination against certain pipelines, consumers and geographic regions. Current regulation-induced disparities among natural gas prices could not be maintained in the free market.

Eliminating the gas price "cushion" brought about by forever-regulated gas will also end the subsidy which NGPA provides for the purchase of foreign natural gas and LNG imports. With all gas flowing at a market-determined price, purchasers will have no incentive to buy high-cost imports; no regulated gas will remain in their inventory to mitigate the impact of the high-cost imported gas increment on the pipeline's average gas purchase cost.

Therefore, as to prospective gas purchases, the advantage enjoyed by foreign gas providers will end. In addition, total deregulation of U.S. gas production at the wellhead will put more pressure on current sales of gas imports into the U.S. market, and could help convince sellers of this gas that they must decrease their current prices or suffer loss of current markets to deregulated domestic gas. In short, the American consumer will be the major beneficiary of natural gas decontrol, as the discipline of wellhead market pricing confronts sellers of imported gas and mitigates market disorders largely induced by NGPA.

In addition, NGSA will work with the coalition of transporters, users and others who support a competitive natural gas market to achieve other changes needed to ensure that a competitive market for all gas is realized at the earliest possible date, and that an environment exists for maximum development of the nation's natural gas resource base for use by American consumers.

We realize that this hearing will also examine the impact of several "piecemeal" solutions to natural gas problems. Our December 13, 1982 testimony before this Committee regarding the dangers of such short-term "fixes" details the NGSA position on all of these proposals.

Basically, these bills would compound and perpetuate current NGPA-induced problems, such as market disorder, while contributing to gas shortages and higher gas prices in the intermediate and long terms. Proposals aimed at reducing take-or-pay obligations with no consideration for the seller's right to market untaken gas threaten to deprive producers of legitimate, bargained-for expectations under current contracts, causing a ripple effect upon financial institutions and investors that have backed the exploration and production activities of the affected producers. Passage of any of these piecemeal proposals would do permanent damage to the industry's ability to provide adequate supplies to future gas consumers.

Formerly, the various piecemeal options were contained in separate bills, each of which was promoted by its sponsor as the answer to current problems in the natural gas market. Recently, however, several of these ideas were conveniently grouped in a proposal which is reportedly being readied for introduction in the House and Senate. The proposal, which is being touted as an alternative to the Administration's bill, was outlined for the public at a recent press conference held by some of its House sponsors. We understand that some labor groups, so-called consumerists, and some distribution companies have indicated support for this legislation.

Basically, the "alternative" would roll-back most natural gas prices to their January 1, 1982 levels while sharply restricting subsequent inflation adjustments. Controls on gas now scheduled for decontrol on 1/1/85 would be extended for a two-year period, and FERC authority to adjust old gas prices to reflect just and reasonable rates would be removed. Take-or-pay requirements in natural gas contracts would be abrogated to the 50% level, and most-favored nation and indefinite price escalation clauses would be forever prohibited. A one-sided right to market-out would be afforded to pipelines, who could exercise it if producers refuse to agree to reduced prices for new or high-cost gas under existing contracts. To assure pipeline use of the combined one-way renegotiation or market-out sledgehammer, the bill also would remove NGPA authority for guaranteed passthrough of purchased gas costs.

It is difficult to conceive of a more counter-productive approach to current problems in natural gas markets. Reduced producer revenues would be insufficient to fund exploration activities necessary to obtain needed future gas supplies. The tightening of controls, combined with their extension for an additional two years, would be a signal to gas producers, financial institutions, and investors that natural gas production revenues may be perpetually subject to government intervention and interdiction. Gas exploration, development and production efforts will decline accordingly, with an adverse and unavoidable long-term impact upon supply and price.

We have not commented previously on S.689, which was introduced March 4 by Senator Heinz. This legislation also fails to provide a comprehensive solution to our natural gas problems, in large part because it continues controls on a large body of regulated gas, with the attendant market disorders already mentioned. In addition, the bill would allow pipelines to abrogate new and high-priced contracts and to reduce take-or-pay obligations to 50%. Such action would threaten the financial stability of producers who have responded to NGPA incentives, and who have attracted investment capital and bank loans to aid in their exploration and development efforts.

The bill also declares the operation of price escalator provisions null and void forever. These provisions play a vital role in long-term natural gas supply arrangements, by guaranteeing to the producer that the price will adjust to reflect changing market conditions over the course of the contract. This is important, because the producer is thereby encouraged to sign a long-term contract, which benefits both the pipeline purchaser and its customers. The pipeline can use the contracted-for gas as collateral in securing additional financing for its operations, and can show to the satisfaction of regulatory officials that it will have a sufficient supply of gas in future years to meet its customer service obligations. If the operation of price escalator clauses is forbidden, producers will be forced to sign only short-term contracts, or to sell gas in the spot market, in order to increase the chance that the price received will reflect market value. This will diminish supply certainties afforded by longer-term contracts, and increase prices to consumers to reflect the greater risk of supply interruption.

In short, S.689 is not a solution to our natural gas problems, because it does not rely upon the marketplace to correct and remove distortions caused by years of counterproductive Federal wellhead price regulation. In fact, like the other piecemeal proposals, it attempts to deny the relevance of market conditions to natural gas supply, demand and price. The inflexibility inherent in such proposals will deprive natural gas consumers of the benefits of wellhead market pricing in the natural gas industry. In the case of oil decontrol, consumers have discovered that market pricing results in adequate supplies at reasonable and competitive prices. We have every reason to expect similar results from deregulation of natural gas at the wellhead.

Those who complain about the rigidity of gas prices under the NGPA would do well to subject recontrol proposals to close examination. Will they aid or obstruct the ability of gas prices to respond to rapid changes in energy markets? The answer is clear. The law of supply and demand, which no government can repeal, makes it very unwise to fix gas prices by Federal fiat.

The Administration's proposal recognizes this fact. It relies upon eventual realization of a competitive market both to balance future gas supply and demand and to guide gas buyers and sellers in adjusting to current market conditions. Achievement of such a market is a realistic and economically sound policy, in contrast to regulation-oriented alternatives which seek to continue the straitjacket of natural gas producer regulation. Accordingly, we call upon the Committee to look forward with us in embracing a flexible, market-oriented policy, such as that contained in the President's initiative, as the appropriate method of meeting natural gas consumers' needs in the modern energy market.

I will be happy to respond to any questions you might have.

The CHAIRMAN. Thank you very much, Mr. Bush.

Mr. Trout?

STATEMENT OF KYE TROUT, JR., CHAIRMAN OF THE BOARD AND PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. TROUT. Good morning and thank you, Mr. Chairman.

My name is Kye Trout and I am chairman of the board and president of the Independent Petroleum Association of America, a national trade association representing America's 15,000 independent oil and gas producers.

I am also a petroleum and natural gas engineer and a producer of oil and gas from Bismarck, N.D., where we often pay more attention to heat than we do eating.

We commend President Reagan for taking steps to decontrol natural gas prices after nearly three decades of counterproductive disincentive controls.

The President's well intended proposals need constructive improvement in our opinion relative to provisions of concern to independent producers.

We would recommend and seek committee revision of the gas cap. We believe and suggest this cap be limited to average price of new gas contracts only. Contracts for the high-cost, deep and imported gas may be renegotiated downward to benefit consumers but that renegotiated price may still be higher than the current market prices for a short time.

On the other hand, old low-cost gas contracts may be negotiated upward but to levels below new gas due to lower delivery rates, smaller reserves and other factors.

We also believe the purchased gas passthrough provisions as they now stand are too restrictive and will discourage renegotiation of contracts. We believe allowances must be made for passthrough of increased purchased gas costs which result from natural gas declines of old, cheaper gas. We are very concerned about any attempt to extend controls beyond January 1, 1986. This would only prolong the agony of the Natural Gas Policy Act which most of us believe has been a total failure.

Our association, Mr. Chairman, is absolutely convinced that full and complete decontrol of all natural gas will benefit everybody, most especially our Nation and its consumers.

The high prices consumers are paying today are the direct result of regulatory machinations under NGPA. Unless Congress moves quickly to decontrol natural gas prices, we could once again experience the pain of shortages and even more erratic prices in the tomorrows ahead.

As our economy improves, demand for natural gas will increase to an estimated demand of about 21.5 trillion cubic feet per year. To meet that demand, producers must drill a minimum of 100,000 wells, new gas wells, I might add; over the next 5 years. In the past 5 years, through 1982 which was our best year in history, we drilled only 75,000 gas wells.

Natural gas development offers tremendous potential for further reducing our dependence on unstable foreign oil sources. We have a domestic natural gas resource base in America sufficient to reduce our present oil imports by half at least, which would amount to at least 2 million barrels per day.

We do understand consumers' concern about high gas prices but we cannot understand how many consumers and some in Congress believe decontrol will result in higher prices. The large increases in gas prices that many consumers are paying is a direct result of pipelines delivering a new mix of predominately higher priced gas to their customers. Since less gas was being delivered per unit, transportation charges of pipelines and distributors increased. As a result, prices went up.

Finally, a number of proposals and legislative packages are being put forward designed to freeze prices and extend control. We find these totally unacceptable and we believe when consumers understand the consequences of these proposals they will find them unacceptable also.

It is an ironic situation that many charge that a flaw of the President's proposals is that decontrolling old gas favors major producers to the disadvantage of smaller independent producers. Yet many of those same people are supporting these proposals which are designed to slap independents in the solar plexus and put us in an economic straitjacket. Independents produce much of the newer gas because they drill 80 to 90 percent of all new gas wells. Larger producers have considerably more leverage in dealing with pipelines than smaller ones.

Yet, the Heinz-Gephardt proposal unilaterally eliminates take-or-pay above 50 percent and outlaws price escalators of any type, two of the most important provisions independents have in maintaining some sort of parity of price and delivery treatment for their smaller volumes.

Mr. Chairman, free markets work. Decontrol works. It worked and is working well for both producers and consumers of oil. It will work for gas. Free enterprise also works in America but natural gas has not had free enterprise for nearly 30 years. It is an idea whose time has come for natural gas prices.

Politicians must quit, I suggest, worrying about the price to be set and allow the market to determine the right price.

Is there anyone in this room, for instance, who wishes we had frozen the price of gasoline and heating oil only 6 months ago? Of course not. It is time to stop believing that natural gas somehow is different from other commodities and let everyone reap the benefits of competition in a free and open market. We will take our chances with a free and open market as we did with the decontrol of crude oil and hope that Congress will afford us the opportunity to do so.

America must have a longer range, more certain supply of natural gas for national security and the needed jobs and economic benefits necessary to economic recovery and development in the 1980's.

Thank you Mr. Chairman, and members of your committee, for this courtesy and the time and attention and privilege to be here.

[The prepared statement of Mr. Trout follows:]

Statement of Kye Trout, Jr., President and Chairman
Independent Petroleum Association of America
Before the Senate Energy and Natural Resources Committee
March 11, 1983

Mr. Chairman:

My name is Kye Trout, Jr. My home base is Bismarck, North Dakota, and I am an independent oil and natural gas producer appearing here as President and Chairman of the Board of the Independent Petroleum Association of America. I am also speaking for the 28 local, state and regional associations listed on the cover of my statement. Together these groups represent virtually all of the 15,000 independent explorer/producers in the United States.

We commend President Reagan for initiating action to come to terms with the greatest remaining impediment to U.S. energy independence, by recommending an end, on a date certain, of 29 years of unnecessary, unwarranted and counterproductive controls of wellhead natural gas prices. We hope the Congress will act expeditiously in responding to the President's initiative, and we appreciate the opportunity to present the views of independent producers to this committee.

Later in my statement there appears a brief one-page statement summarizing our position regarding the Administration proposal. I will speak specifically to some of our concerns and recommendations, but first I would like to make some observations on: (1) the role and investment practices of independent producers, (2) the relationship between price and drilling to provide adequate future gas supplies, and (3) the historic deficiencies in natural gas revenues as a source of funds for domestic petroleum exploration, drilling and development.

At the outset, I would comment that surely no one conversant with conditions now confronting producers and consumers of natural gas would defend the status quo. The Natural Gas Policy Act of 1978 has caused economic distortions that have raised everybody's costs and prices. I realize that the answer that some would recommend would be to tighten regulation, and thus compound past errors. Those who distrust the competitive free market are making the same unsubstantiated fear statements about natural gas decontrol that were made about crude oil decontrol. But it is noteworthy that both crude oil and gasoline are selling today at a price about 10 percent below the prices existing when oil was deregulated in January 1981.

Two principal errors are made by opponents of deregulation: first, that market pricing results in "windfalls" that simply line the pockets of producers, and second, as increased revenues are not committed to new exploration and production, and that no supply benefit to consumers occurs. There is nothing in industry experience to substantiate such conclusions, and the evidence in fact is all to the contrary.

For example, independent oil and natural gas producers as a group consistently have reinvested in exploratory drilling, development and production activities the equivalent of 105 percent of their gross revenues from wellhead sales of petroleum fuels. Chart I showing these relationships,-based on data from the annual survey of oil and gas by the U.S. Census Bureau, shows that in the eight-year period 1973 through 1980, wellhead revenues of independents totalled $77.7 billion while their expenditures totalled $81.1 billion. Throughout this period of rising revenues, industry expenditures for accelerated drilling, development and production at rising costs exceeded revenues in all but two of the eight years.

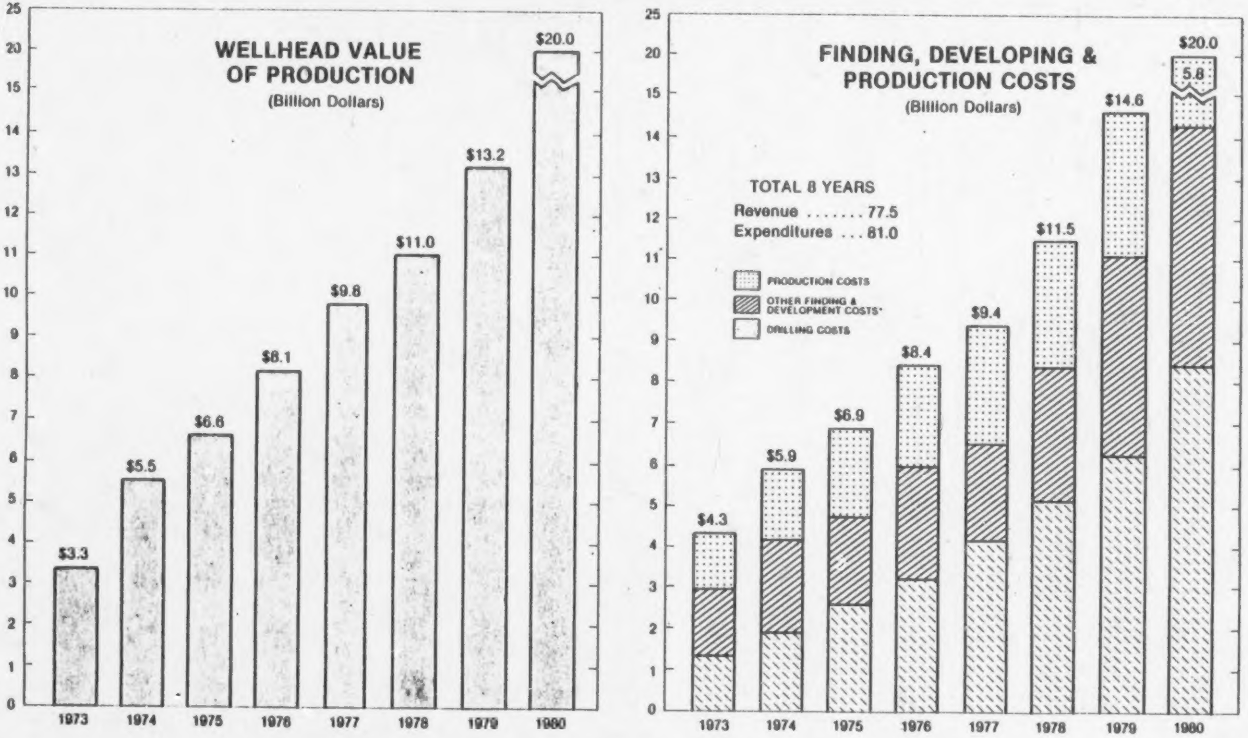
As the industry as a whole has increased its effort to provide more petroleum fuels, it is significant that independent producers have increased their share of this activity. In Chart II, "Gas Well Completions in the U.S.," for example, the share of total gas wells drilled by independent producers are

Chart I

INDEPENDENT OIL & GAS PRODUCERS

(ALL U.S. PRODUCERS EXCEPT THE 24 LARGEST COMPANIES)

1973-1980



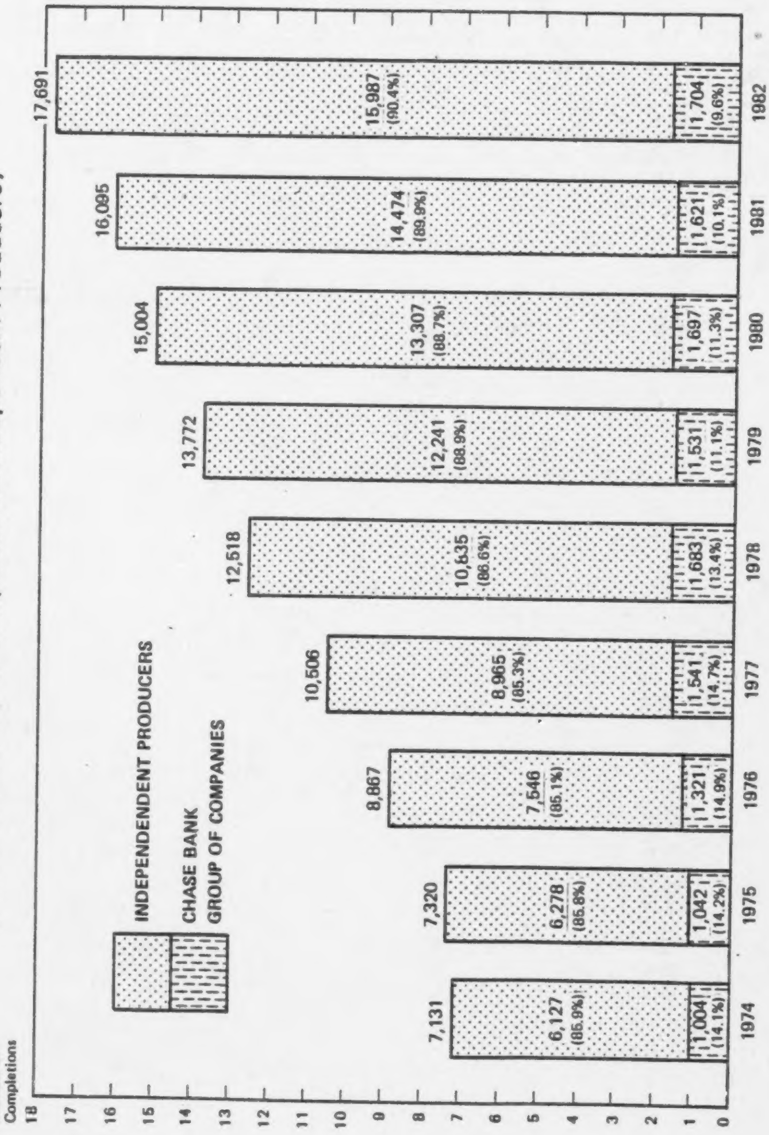
*Includes geological and geophysical; lease and land acquisition; test hole contributions, etc.
Source: U.S. Bureau of the Census, "Annual Survey of Oil and Gas".

IPAA CHART

Chart II

GAS WELL COMPLETIONS IN THE U.S.

(Chase Bank Group of Companies vs. Independent Producers)



Source: Petroleum Information, Inc.

IPAA CHART
MARCH 1983

compared with well completions by the so-called "Chase bank group" of some 26 larger companies. It will be noted that independents accounted for more than 90 percent of the 17,671 gas wells completed in 1983, whereas their share of total wells averaged less than 86 percent in the years prior to 1978 when far fewer wells were drilled.

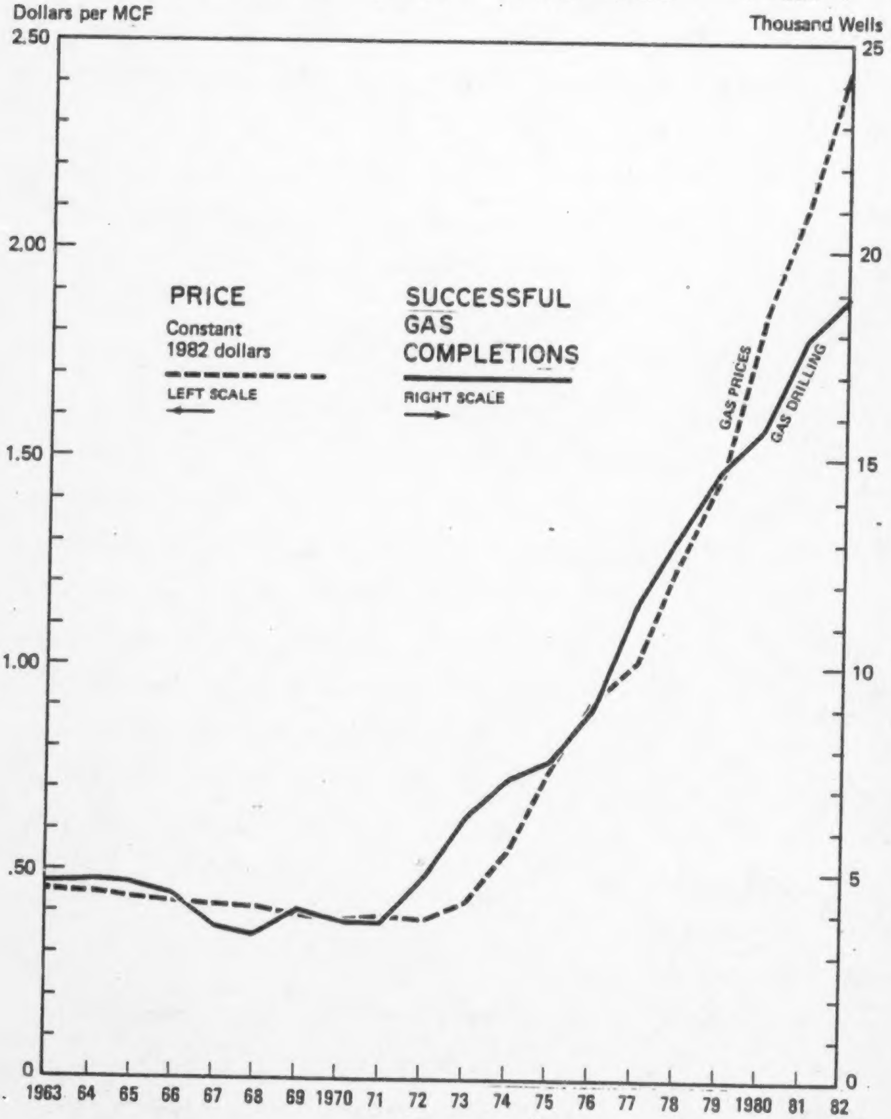
It is important to realize that a distinct correlation exists between gas well drilling and natural gas wellhead prices. This correlation is made clear in Chart III, with gas well drilling tracking almost precisely the wellhead price expressed in constant dollars.

I call attention to these facts only to demonstrate that there is every reason for confidence, based on historical industry behavior, that the consumer will be the beneficiary if the Congress acts to restore competitive market forces as the principal engine for eliciting, allocating and pricing natural gas. It is clear that the years just ahead will require maximum efforts if we are to continue to meet the nation's requirements for this essential fuel. The recovery now occurring, coupled with removal of existing demand impediments through the repeal of the Fuel Use Act and incremental pricing provisions of NGPA, can be expected to restore normal demand for natural gas -- about 21.5 trillion cubic feet per year. To meet even this normal demand expectation and maintain the existing reserve/production ratio will require the drilling of about 100,000 new gas wells in the next five years. In the five years ending in 1982, for comparison, we drilled only 75,000 new gas wells.

But many economic analysts believe decontrol would give domestic natural gas such competitive advantage in the energy market that supplies would expand substantially beyond normal expectation. One analysis by University of Michigan economist Glen Loury, for example, concludes that deregulation would result in displacement of 2,000,000 barrels daily of foreign oil in the U.S. market in three to five years. This would be a major step toward U.S. energy

Chart III

GAS DRILLING FOLLOWS GAS PRICES



Source: Department of Energy and American Petroleum Institute

IPAA CHART
MARCH 1983

independence, and represents an opportunity that would require drilling a significantly larger number of wells than would the resumption of "normal" demand which I have discussed.

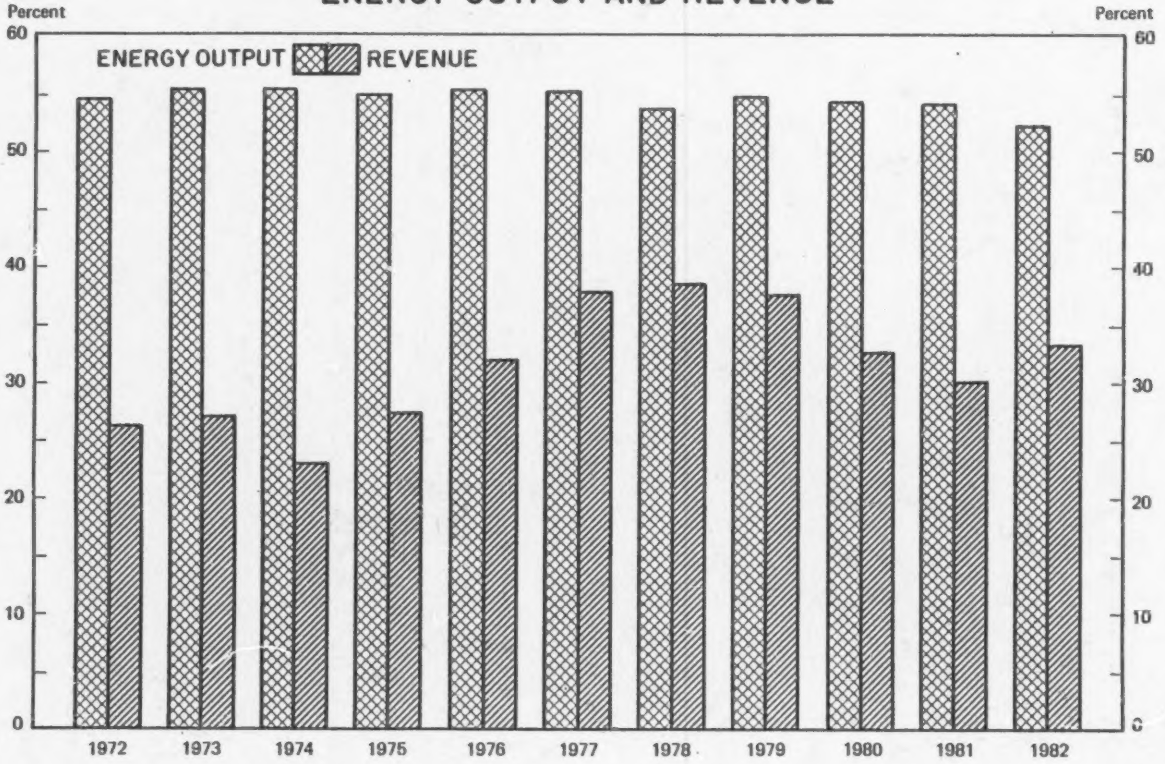
Our analysis indicates that displacement of 2,000,000 barrels daily of imported oil by 1988 would require the drilling of over 180,000 total successful gas wells in the next five years. This would necessitate an average annual natural gas drilling rate nearly 100 percent above the peak drilling year, 1982.

Unquestionably, Mr. Chairman, we possess a natural gas resource base adequate to materially displace one-half or more of our present oil imports of approximately 4,000,000 barrels daily. It is our belief that would occur because a competitive free market would generate natural gas exploration and drilling that would result in expanding supplies of gas at prices competitively attractive when compared with OPEC oil. Not only would market pricing for all gas unleash greater domestic supplies and reduce dependence on foreign energy, but I believe restoration of a fully competitive gas producing industry would represent a new dynamic that would further undermine effective cartelization of world oil prices and markets.

Before getting to the specifics of the President's proposal, I would call attention to one more fact of life that has characterized domestic natural gas production. Chart IV illustrates an economic disparity that has existed for many years -- this being that natural gas represents more than half of the wellhead energy produced by the domestic petroleum industry, but generates only about one-third of the revenues attributable to both oil and gas. In other words, natural gas has never generated its share of funds expended for petroleum exploration, drilling, development and production.

Chart IV

NATURAL GAS SHARE OF TOTAL U.S. WELLHEAD ENERGY OUTPUT AND REVENUE



IPAA CHART
MARCH 1983

Although geologists are almost of a single mind that domestic supply prospects for natural gas exceed those for crude oil, we will again see twice as much drilling for oil in 1983 as for gas. Removal of the supply impediments built into the Natural Gas Policy Act by deregulation and the demand impediments by repeal of the Fuel Use Act would, Mr. Chairman, restore a competitive industry that would assure consumers of growing supplies at reasonable prices for the forseeable future. I do not believe a scintilla of reliable evidence exists which can refute this expectation.

Now, I would like to turn to the economic aberrations that producers and consumers have experienced under the NGPA, review our Association's policy positions, and, finally, suggest the modifications which we believe would strengthen and perfect the Administration's legislative proposal.

Following passage of NGPA, independents set about certifying their wells and their contracts. By early 1980, it was becoming apparent to many that the NGPA was not working well.

Because such a small body of gas (wells drilled below 15,000 feet) was free from price controls, many eager buyers in a yet booming, high inflation economy were offering previously unheard of contracts to producers. Not only were prices triple the level of new gas subject to NGPA ceilings, but high guaranteed rates of take were being offered as well as extremely lucrative "decontrol clause" provisions.

Because nearly all of that part of NGPA gas subject to decontrol after 1985 contained these decontrol escalator clauses, we began to hear about a massive 1985 price "fly up".

While those on interstate pipelines were concerned about the potential impact of this "fly-up", those most concerned were operators of the intrastate lines and their customers. Since intrastate pipelines do not enjoy the old gas cushion created by NGPA, any such fly up would impact a high percentage of their total volumes, while interstate pipelines would normally expect less than half of their volumes to be effected.

As a result, intrastate lines could not afford to bid for new gas supplies because they could not offer the favorable terms being offered by the cushioned interstate lines.

Looking at this and other problems, IPAA's Natural Gas Committee began in 1980 a year-long study to determine what independent producers should recommend in the way of new national policy.

In early 1981, the Association's new policy was adopted with three main elements.

1. Decontrol all gas at the earliest possible date;
2. Repeal the Fuel Use Act and incremental pricing provisions of NGPA;
3. Oppose any new taxes on the gas industry.

Since that policy was adopted, we have testified on four different occasions before this Committee urging Congressional action to achieve its goals. For more than two years, we have warned that NGPA was not working and that political and economic troubles were in store if changes were not forthcoming.

Along the way, we have had some clear signals of these problems. Because of the inability of intrastate lines to secure new supplies, we began hearing more than a year ago of threatened shortages of gas for customers in Louisiana, Texas, and Oklahoma. We are told, by a number of those pipelines and their major industrial users, that probably the only thing that saved us from curtailed industrial facilities in those states due to a shortage of gas, was the fact that the recession closed plants before the shortages did.

Without fanfare, the fly up that we had feared in 1985, hit consumers in late 1982. As the recession and warm weather cut demand to the major interstate pipelines, a funny thing happened. Driven by more stringent contract "take" provisions in newer contracts and a desire to stretch out the "old gas" cushion advantages as long as possible, many pipelines started delivering a new "mix" of gas to their customers. Since less gas was being delivered, per unit transportation charges of pipelines and distributors went up. The cheaper cushion gas tended to be shut in first. For both of these reasons, average purchased gas prices increased sharply.

If that wasn't enough, a number of imported gas and LNG projects came to fruition, compounding the burner tip problem.

Congressional response during the 1982 elections is now history and we need not rehash the thrust of proposals in the "lame duck" session. It should be noted, however, that the complexity of this issue with its attendant levels of misunderstanding, is exemplified by many of those lame duck proposals as well as many pieces of legislation now before this committee. Frustration grew over increased pipeline and distribution charges caused by reduced volumes, increased use of higher priced deep gas and imported gas and high interest rates -- all compounded by the general state of the economy. This frustration led to a proposed rollback of wellhead prices to domestic producers. Can you imagine the frustration of a domestic producer being asked, in effect, to pay the price for unpopular, unneeded Algerian LNG?

In the face of all this counterproductive legislation, even though we have some reservations about it, the Administration's comprehensive natural gas proposal brought some hope for a sound solution to the problem.

Meeting last week here in Washington, IPAA's Executive Committee adopted the following statement:

"For a number of years, we have supported the early decontrol of all natural gas without a windfall tax and the repeal of end use controls.

The Reagan Administration has proposed legislation which broadly seeks to achieve those three IPAA stated goals. We commend that effort.

However, we feel a number of changes need to be made in the Administration proposal as it moves through Congress in the coming months.

First, we are concerned that the elements of the proposed "gas cap" are too restrictive. Elements of that cap should avoid, to the extent possible, a rollback of the price of existing gas contracts.

Secondly, the consumer protection provisions involving limits on purchased gas prices which can be passed through to consumers are too narrow. Unless true market prices are allowed to be tested in the ultimate market, consumer response to needed levels of production will be thwarted. If this occurs, new exploration will decline to the point that future shortages could be expected. Such shortages would almost certainly bring about higher prices to those who are supposed to be protected by this provision.

Thirdly, many producers are being asked by this legislation to accept an extension of both direct and indirect controls beyond dates in the existing law. Any efforts by Congress to extend those dates beyond January 1, 1986 will be unacceptable.

The IPAA supports the Administration's intent to decontrol all natural gas prices by January 1, 1986 and we will actively seek to amend the proposed legislation to fulfill the aforementioned concerns."

Let us highlight our three major concerns.

First, we will seek Committee Amendments to revise the elements of the "gas cap". If, as has been stated, it is the object of the "gas cap" to cause pricing clauses of new NGPA gas contracts to be reflective of true market prices, then we believe the cap should be limited to an average of new gas contracts only. Contracts for high cost and imported gas may be renegotiated downward to the benefit of consumers, but that renegotiated price may still be higher than current market -- at least for a short time. On the other hand, old low cost gas contracts may be renegotiated upward, but to levels below new gas due to lower delivery rates, smaller reserves and similar factors. In neither case would they be reflective of today's commodity value of gas and this would distort the cap unnecessarily.

We also will seek amendments to the purchased gas passthrough provisions of the bill. As they stand today, we believe they are too strict and will work to discourage the renegotiation of contracts which the bill seeks. A pipeline unable to engage in renegotiation and new gas purchasing due to the overly tight limits of this provision, could be faced with an inability to retain existing reserves or secure new supplies and to the end that consumers served by that pipeline may experience future shortages.

As a minimum, we believe provisions should be made to allow for the pass-though of the increased purchased-gas costs which result from natural production declines of old cheaper gas. Even under crude oil price controls Congress recognized natural decline rates of producing wells. In addition, the new proceedings at FERC for approving purchased gas costs should be expeditious. Ideally, increased costs should be able to be passed through subject to review and refund. However, as a minimum, a short time limit, say 45 days, should be placed on FERC action. Unless something is done to move these proceedings faster than normal, such cases will remain under review past the duration of the legislation.

One of the most important aspects of the Administration proposal is the time certain for decontrol. As our statement says, any extension of the date in the bill will be unacceptable.

For many producers, the immediate impact of the President's proposal will be a rollback in prices, a loss of price escalator clauses and a loss of potential cash flow through mandated reduction in take or pay guarantees. Most of this burden will fall on independents.

Producers are willing to run those downside risks to the short term in return for assurance at an early date of a free, and hopefully expanding market. But if that "short term" gets extended, the free market promise will become too shallow for them to accept. We urge you to stick with the timetable of the proposal.

Before concluding, we must comment briefly on the concepts embodied in the so-called Heinz-Gephardt proposal. We find that proposal to be totally unacceptable and we believe if consumers really understood it, they would oppose it too. It takes all of the failures of NGPA, amplifies them and extends them.

It is ironic that many have charged that one of the flaws of the President's proposal is that by decontrolling old gas it favors major producers to the disadvantage of smaller, independent producers. Yet many of those same people are proposing and supporting Heinz-Gephardt which is designed to slap independents in the economic solar plexus.

Independents produce much of the newer gas. Heinz-Gephardt extends controls on that gas and legislatively rolls back its price. Larger producers have considerably more leverage in dealing with pipelines than smaller ones. Yet Heinz-Gephardt unilaterally eliminates take-or-pay above 50 percent and outlaws price escalators of any type -- two of the most important provisions independents have in maintaining some sort of parity of price and delivery treatment for their smaller volumes. Not only does it abrogate those provisions, but it gives producers no "out" of the rest of the contract no matter how onerous it becomes absent the outlawed provisions.

Decontrol works. It worked and is working well for both producers and consumers of oil. It will work for gas.

It is time to quit worrying about whether one class of producers will fair better than another if this or that category of gas is removed from controls. It is time to remove all controls and let gas as a single priced commodity compete in the market place of alternate fuels. Producers will be best served by that. Consumers will be best served by that. And politicians can quit worrying about what price to set and let the market determine the right price. We have proven once again under NGPA that arbitrary political prices are wrong and benefit no one.

Is there anyone in this room that wishes we had frozen the price of gasoline and heating oil six months ago? Of course not. It's time to quit believing natural gas somehow is different from other commodities and let everyone reap the benefits of competition in a free market.

The **Chairman**. Thank you very much.
Mr. Barber.

STATEMENT OF PERRY O. BARBER, JR., GENERAL COUNSEL, PENNZOIL CO., ON BEHALF OF THE DOMESTIC PETROLEUM COUNCIL

Mr. **Barber**. Mr. Chairman, I likewise feel at home before this committee. We have operations in Ohio and Nevada and in Pennsylvania and have long been active in Alaska and our chairman was born in Oklahoma. We are happy to be here today.

I am a general counsel of Pennzoil Co. and I am appearing here today on behalf of the Domestic Petroleum Council [DPC].

DPC is an organization of 20 medium-sized companies whose business is domestic exploration and production of oil and natural gas.

Let me start by applauding both Chairman McClure and the President for choosing to address one of the most controversial issues facing the Nation today, the extent to which the Federal Government will continue to regulate the wellhead sales of natural gas in this country.

No one who experienced the seemingly endless series of hearings and debates that led to the passage of the Natural Gas Policy Act in 1978 can refuse to acknowledge your courage and determination in facing this issue at this particular time.

The nationwide problems generated by the NGPA are adversely affecting producers and consumers of gas alike and the problems cry out for a comprehensive solution. A piecemeal solution is no solution at all nor is it a solution to preserve or attempt to preserve the benefits, if any, of the present scheme of regulation to a favored few while at the same time relieving those favored few of any of the burden.

The DPC is convinced that S. 615 represents a good-faith attempt at a comprehensive solution. It is carefully, some have said even elegantly designed to give each segment of the gas industry, the pipelines, both interstates and intrastates, the distributors and the consumers, some but not all of the relief each has contended for in recent months.

In short, it recognizes that each segment of the industry has a stake in a comprehensive solution and that the burdens of transition from the present chaotic condition should be equitably distributed among all segments of the gas industry.

We enthusiastically embrace both the objective and the concept of an equitable transition to a free market and we will work for such an equitable solution within the framework of S. 615.

However, in all candor, we feel that S. 615 places a disproportionately heavy burden on the producer. The producer is already bearing the brunt of the reduced demand for natural gas and under S. 615, he would bear substantial additional burdens. These burdens include the following:

Until 1986, every producer must be prepared to suffer a rollback in price on each and every existing contract that does not fall under section 107 of the NGPA. Also until 1986, producers must be prepared to give up any take-or-pay protection above 70 percent in their existing contracts. The pipeline will also have the right to select categories of gas behind the contract which will be reduced in takes. On top of this, we must be prepared by 1985 to give up all of our favorable contracts whether deregulated, deep gas, high-cost gas, new gas, or old gas. Of course, we will have the right to rescind our unfavorable contracts if we can find someone who will give us better terms and can afford the additional transportation expenses involved.

Clearly, the risk is on us. In summary, the producer bears the primary brunt of the transition to the termination of Federal price, contract and allocation controls, as compared to the pipelines and distributors. Thus, in the context of existing revenue losses, the producer faces the reality of a further loss of revenue. No other sector of the industry faces this under S. 615.

We firmly believe that we should seek a solution which is fair to all and we look forward to working with the Congress within the framework of S. 615 to achieve that objective.

[The prepared statement of Mr. Barber follows:]

STATEMENT OF PERRY O. BARBER, JR.
GENERAL COUNSEL, PENNZOIL COMPANY
ON BEHALF OF
THE DOMESTIC PETROLEUM COUNCIL
ON S.615
THE "NATURAL GAS CONSUMER REGULATORY
REFORM AMENDMENTS OF 1983" AND OTHER BILLS
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

MARCH 11, 1983

Mr. Chairman, Members of the Committee, my name is Perry O. Barber, Jr. I am the General Counsel of Pennzoil Company and I am appearing today on behalf of the Domestic Petroleum Council (DPC). The DPC is an organization of twenty medium sized companies whose business is domestic exploration and production of oil and natural gas. A list of the member companies of the DPC is attached as an appendix.

Mr. Chairman, we appreciate the opportunity you have provided us to present our views on the Administration's "Natural Gas Consumer Regulatory Reform Amendments of 1983."

Let me start by applauding both Chairman McClure and the President for choosing to address one of the most controversial issues facing the nation today: the extent to which the Federal government will continue to regulate the wellhead sales of natural gas in this country. No one who experienced the seemingly endless series of hearings and debates that led to passage of the Natural Gas Policy Act (NGPA) in 1978 can refuse to acknowledge your courage and determination in focusing attention on this issue at this time.

The nationwide problems generated by the NGPA are adversely affecting producers and consumers of gas alike, and the problems cry out for a comprehensive solution. A piecemeal solution is no solution at all. Nor is it a solution to preserve, or attempt to preserve, the benefits, if any, of the present scheme of regulation to a favored few while, at the same time, relieving those favored few of any of the burdens.

The DPC is convinced that S. 615 represents a good faith attempt at a comprehensive solution. It is carefully, some have said even "elegantly," designed to give each segment of the gas industry--the pipelines (both interstates and intrastates), the distributors and consumers--some, but not all of the relief each has contended for in recent months. In short, it recognizes that each segment of the industry has a stake in a comprehensive solution and that the burdens of transition from the present chaotic condition should be equitably distributed among all segments of the gas industry. We enthusiastically embrace both the objective and the concept of an equitable transition to a free market. And we will work for such an equitable solution within the framework of S. 615.

However, in all candor, we feel that S. 615 places a disproportionately heavy burden on the producer. The producer is already bearing the brunt of the reduced demand for natural gas. In my company, for example, in 1981 we delivered approximately 600,000 Mcf per day. As a result of recently announced reductions in takes by our principal pipeline purchaser, we will be selling approximately 180,000 Mcf per day until further notice. Although we had budgeted takes at a level substantially below our delivery capacity, these recent volume reductions and reductions in price by the same pipeline purchaser will result in substantial further revenue reductions in 1983. The producer can ill afford to bear the further burdens imposed by S. 615.

These burdens include the following:

Until 1986, every producer must be prepared to suffer a rollback in price on each and every existing contract that does not fall under Section 107 of the NGPA. 1/ This will occur through operation of the transitional gas cap mechanism, a procedure that puts the producer in the situation of getting no more than he would have received under the existing NGPA and running the risk of getting considerably less. There is no limit on how far or how fast prices can drop; there is only a limit on how high--which is nothing over the status quo for regulated gas and a new cap on otherwise deregulated gas, now or in 1985. Reductions in our revenues make it more difficult to maintain our exploration and development programs.

Also until 1986, producers must be prepared to give up any take-or-pay protection above 70% in their existing contracts. 2/ The pipeline will have the right to select categories of gas behind a contract which will be reduced in

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1/ See new Section 111 of the NGPA contained in Section 301 of S. 615.

2/ See new Section 315 of the NGPA contained in Section 302 of S. 615.

takes. The further adverse impact on our cash flow could be significant, and our only recourse is to attempt to sell the shut-in volumes to another purchaser. With the markets in the chaos I have described, this is likely to be an empty right.

On top of this, we must be prepared by 1985 to give up all of our favorable contracts, whether deregulated deep gas, high cost gas, new gas or old gas. 3/ Of course, we will have the right to rescind our unfavorable contracts, if we can find someone who will give us better terms and can afford the additional transportation expenses involved. Clearly, the risk is on us.

It is equally clear that it is the interstate pipeline which has the negotiating advantage in dealing with the producer. Since the passage of the NGPA, the interstate pipelines have had the bidding advantage over intrastate pipelines. The interstate pipelines, with their cushions of cheap price controlled gas, have been able as a class to offer higher prices, if deregulated, or the NGPA ceiling prices plus better take-or-pay and deregulation clauses than can the intrastates and have thus been able to contract for the majority of supply.

In addition, it is the interstates who have been allowed preferred access to OCS gas in the Gulf of Mexico. Even if this were not the case, the interstate pipelines represent a market about twice as big as the intrastates, and thus are--and will remain--the major purchasers. Further, the

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3/ See new Section 316 of the NGPA contained in Section 303 of S. 615.

restrictions in S. 615 on the FERC pipeline rate cases--which apply only to the purchased gas portions of the rate cases--increase their negotiating power because the interstate pipelines will necessarily limit any offer made to a producer to levels which can be immediately passed through in their puchased gas adjustment filings.

Finally, allowing distributors and industrial and utility users to enter the field markets for gas will further toughen the pipelines' negotiating position, since the incentive for the pipelines' customers to obtain a supply in the field will be reduced if the pipelines can lower purchased gas costs through harder bargains with producers.

In summary, the producer bears the primary brunt of the transition to the termination of federal price, contract, and allocation controls, as compared to pipelines and distributors. The producer faces the reality of a further loss in revenues; no other sector of the industry faces this.

We firmly believe that we should seek a solution which is fair to all. And we look forward to working with the Congress, within the framework of S. 615, to achieve that objective.

Comment was requested on other pending bills.

S. 689, the Natural Gas Policy Act Amendments of 1983, has as its first stated purpose to "provide mechanisms for a smooth transition to the ultimate decontrol of certain wellhead natural gas prices." 4/ The explanation adds that

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4/ S. 689, 98th Cong., 1st Sess., 129 Cong. Rec. S2136 (daily ed. March 3, 1983).

the bill retains the "Natural Gas Policy Act phased decontrol schedule for new gas." 5/ Neither the purpose nor the explanation is carried out in the bill. To the contrary, the bill imposes permanent controls on all gas contracts, confers exclusive jurisdiction on the FERC, instead of the Courts, to interpret contracts and, significantly, reimposes the indirect controls over wellhead prices by the FERC which were specifically rejected in the NGPA. 6/ In short, S. 689 should be characterized as a re-regulation bill which also gives to certain distribution companies and others a legislative victory in cases they lost at the FERC or in court.

As one example, the bill would reverse the holding of the Commission in 1979 7/ and the holding of the Fifth Circuit 8/ that area rate clauses could operate to allow producers to collect NGPA ceiling prices, including an inflation

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5/ Id. at S2138.

6/ Natural Gas Pricing Agreement adopted by the conferees on H.R. 5289, 95th Cong., 2d Sess. Committee Print 95-99 (1978), at 19.

7/ The Commission's determination was made in a series of orders in FERC Docket No. RM79-22: Order No. 23, Amendment and Clarification of the Commission's Interim Regulations Implementing the Natural Gas Policy Act of 1978 and Regulations Under the Natural Gas Act, (March 13, 1979); Order on Rehearing of Order No. 23, (May 11, 1979); Order No. 23-A, Amendment and Clarification of Interim Regulations Under the Natural Gas Policy Act of 1978 and Regulations Under the Natural Gas Act (June 12, 1979); Order No. 23-B, Adopting Final Regulations and Establishing Protest Procedure (June 21, 1979); Order on Rehearing of Order No. 23-B (August 6, 1979); Order on Rehearing of Order No. 23-A (August 13, 1979).

8/ Pennzoil Co. v. FERC, 645 F.2d 360 (1981), cert. denied, 454 U.S. 1142 (1982).

adjustment provided in the statute. Even though Chairman Dingell testified that these decisions were in accord with the intent of the NGPA, 9/ certain distributors and others have long sought to freeze gas prices as low as $.30 and not allow even an inflation adjustment. 10/ This bill gives them the victory denied them by the NGPA, the FERC, and the Courts. 11/ In fact, it could impose a crushing refund obligation of billions of dollars upon producers not only denying them the inflation adjustments to keep them whole on their flowing gas

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9/ Statement Of The Honorable John D. Dingell, Chairman, Subcommittee On Energy And Power of the Committee On Interstate And Foreign Commerce, U.S. House Of Representatives, On The Operation Of Indefinite Price Escalator Clauses Before The Federal Energy Regulatory Commission in Docket No. RM79-22, (January 19, 1979).

10/ See, e.g., Joint Brief of Consumer Petitioners and Intervenors at 25-28 in Pennzoil, supra, fn.8.

11/ The bill would also repeal Commission actions on a number of other questions arising under the NGPA. Specifically, the bill would repeal Order No. 93-A, 15 FERC (CCH) ¶ 61,075, Docket No. RM80-33 (issued April 24, 1981), which established the standard for measuring gas sold under the NGPA; Order Nos. 94-A and 94-B, Docket Nos. RM80-47-002 and RM80-47-003 (issued January 24, 1983), and related orders, which established allowances for producers incurring certain "production-related costs;" a Declaratory Order, Indicated Producers--Shell Oil Company, et al., 22 FERC (CCH) ¶ 61,013, Docket Nos. GP82-50, et al. (issued January 17, 1983), which held that receipt by a producer of transportation services for liquid and liquefiable hydrocarbons cannot give rise to a violation of NGPA ceiling prices; and the Statement of Policy, Fraud Standard in Section 601(c)(2) of the NGPA, 18 C.F.R. § 2.300 (1982), Docket No. PL82-1 (issued February 4, 1982), which interpreted the NGPA to guarantee pass-through of purchase gas costs incurred by pipelines in paying NGPA prices except in cases of "misrepresentation." The bill would also give the Commission review power over all contracts.

prices but also penalizing them for having undertaken drilling for gas in response to the NGPA.

Indeed, S. 689 would impose measures that can only be characterized as punitive. For example, take-or-pay rights are limited to 50 percent of deliverability. But in a report prepared at Senator Eagleton's request, the GAO was unable to conclude that take-or-pay clauses were the cause of the increased gas prices at the burner tip. 12/ Further, the FERC has found that take-or-pay problems are sufficiently insignificant that they don't even warrant the granting of temporary certificates on major pipelines so that they can increase their gas sales volumes. 13/

The remaining bills were essentially covered in the hearings before the Committee in December, 1982. These bills single out one or more issues for quick fixes. They may be characterized as wellhead price freezes or take-or-pay fixes or abrogation of indefinite price escalator clauses. Freezing the price of the U.S. producer will not necessarily result in lower prices if Canadian, Mexican, Algerian or other sources of gas, including high cost gas, are substituted. The same comment applies to take-or-pay. Why shut in U.S. production to make room for imported gas supplies? 14/

12/ General Accounting Office, Natural Gas Price Increases: A preliminary Analysis GAO/RCED-83-76 at ii and iii (December 9, 1982).

13/ See fn.27, infra.

14/ S. Res. 75 introduced by Sen. Percy and others addresses the impact of high cost imported gas supplies. S. Res. 75, 98th Cong., 1st Sess., 129 Cong. Rec. S1756 (daily ed. Feb. 28, 1983).

A good illustration of this point is found in the recent testimony of El Paso Natural Gas Company before a House subcommittee. 15/ At that time, the witness for the largest pipeline in the U.S. stated that his company had no take-or-pay problem with producers. In fact, his company supplied California consumers with the cheapest interstate gas supply available, yet El Paso was losing markets. Why? Because preference was given to pipelines bringing in Canadian supplies--at up to $8 per MMBtu, I might add, as compared to El Paso's $3.70 per MMBtu--and to another interstate pipeline supplier who, though higher priced, had a higher minimum bill--a take-or-pay, if you will (but one without make-up rights)--than did El Paso. An additional problem was that the California PUC adopted a rate design which gave residential consumers a subsidized gas price at the expense of the industrial and utility user, resulting in a shift of industrial load to oil and a corresponding loss of gas markets.

El Paso thus complained that the federally approved minimum bills for Canadian and another interstate pipeline's gas and a rate design adopted by a State resulted in a loss of markets, and suggested that El Paso not be blamed. I agree that El Paso should not be blamed, but I even more strongly urge that the producers who sell to El Paso not be blamed

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15/ Supply Projections; Possible Effect on Supply of Proposed Actions Affecting Contracts, Imports, Price Ceilings; Hearings Before the Subcommittee on Fossil and Synthetic Fuels of the House Committee on Energy and Commerce, 97th Cong., 1st Sess. (Feb. 22, 1983) (Written Statement of El Paso Natural Gas Co.) (Mimeo).

either and forced to cut their prices so that the Canadian and other pipeline suppliers can maintain their market share.

And, so I won't be accused of singling out California, I note that in October the residential gas user in the New York area was paying $7.71 per MMBtu on average for his gas 16/ while Con Ed was paying only $3.95 per MMBtu for boiler fuel. 17/ Incidentally, Con Ed was paying $5.09 per MMBtu for oil that same month, 18/ and residential users were paying $8.80 per MMBtu for oil at that same time. 19/ This makes me wonder about some of the claims that producer prices are out of line with burner tip prices. After all, domestic producers selling to major interstate pipelines were recovering about $2.80 per Mcf on average during the previous month. 20/ Indeed, the average wellhead price on gas sold to the interstate pipelines

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16/ Energy Information Administration, U.S. Department of Energy, Natural Gas Monthly, DOE/EIA-0130(83/01), Table 11 at 30 (January, 1983).

17/ Energy Information Administration, U.S. Deparment of Energy, Cost and Quality of Fuels for Electric Utility Plants, DOE/EIA-0075(82/10), Table 33 at 48 (October, 1982).

18/ Id.

19/ Energy Information Administration, U.S. Department of Energy, Monthly Energy Review, DOE/EIA-0035(83/01) Residential Heating Oil Prices by Region at 87 (January 1, 1983). Average No. 2 heating oil price to residential consumers in Region 2 (New York and New Jersey) = $1.22 per gallon, or 7.21 gal/MMBtu x $1.22/gal = $8.80 per MMBtu.

20/ Natural Gas Monthly, Table 10 at 29. This is the September, 1982 figure, the latest one available.

serving New York State ranged from $1.34 Mcf to $2.90 Mcf in mid-82. 21/

Furthermore, as both GAO and EIA found, the average price of gas at the wellhead last year was mainly driven by mix change (the relative volume of gas in the NGPA categories), not by increases in price for regulated gas, which went up only 4%. 22/ I am not prepared to accept as established that the wellhead price of natural gas explains why "natural gas prices are currently above market-clearing levels in many markets. 23/ On this general proposition, the Chairman of the FERC recently provided a study to Mr. Sharp which can only be called inconclusive. 24/ If there are "many markets" where this is true, I would like to see the evidence, if any, on where these markets are, and then I would like the opportunity to see whether the cause of market clearing prices is prices paid domestic producers or whether there are other causes, such as Canadian, Mexican, and Algerian imports; or pipeline purchasing practices like those detailed by the FERC Adminis-

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21/ Energy Information Administration, Department of Energy, An Analysis of Post NGPA Interstate Pipeline Wellhead Purchases--An Analysis of the Natural Gas Policy Act and Several Alternatives, Part III, DOE/EIA-0357; Appendix 13, Tables at 78, 82, 122, 126 and 134 (Sept. 1982).

22/ GAO, Natural Gas Price Increases: A Preliminary Analysis, at 11; EIA, An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases at 37.

23/ Section 101(3) of S. 689, 129 Cong. Rec. S2136 (daily ed. March 3, 1983).

24/ Response by Chairman Butler to questions contained in Chairman Sharp's letter of Dec. 9, 1982 to Butler (Jan. 27, 1983) (unpublished).

trative Law Judge in the Columbia case; 25/ or perhaps rate designs implemented by the FERC or a State Commission.

Indeed, we have seen several interstate pipelines seek FERC approval to make low-cost sales to industrial customers. And then what happened? In one instance, the pipeline withdrew its request when the Commission placed some risk of the marketability claimed for the gas by the pipeline on the pipeline making the claim. 26/ In the remaining instances, the FERC vacated the temporary certificates it had originally issued, finding no emergency existed. Thus, in those situations the take-or-pay situation on the pipelines did not rise to a level which the Commission considered sufficient to warrant issuance of a temporary certificate. 27/ It is unjust and unfair to call upon producers to finance lower burner tip prices under circumstances in which the pipelines and distributors seek insulation from any market risk themselves or upon facts determined by the FERC as not exhibiting take-or-pay conditions sufficient to warrant issuance of temporary certificates.

I wish to point out a further inconsistency which clouds the debate, and I will use S. 689 as an illustration.

25/ Columbia Gas Transmission Co., 21 FERC (CCH) ¶ 63,100, Docket No. TA81-1-21-001 (issued Dec. 30, 1982).

26/ Columbia Gas Transmission Co., 21 FERC (CCH) ¶ 61,326, Docket No. CP82-485 (issued Dec. 22, 1982). Letter from Columbia Gas Transmission Co. to the Commission (Jan. 3, 1983) (declining acceptance of Temporary Certificate).

27/ Northern Natural Gas Co., 22 FERC (CCH) ¶ 61,173, Docket No. CP83-14 (issued Feb. 18, 1983).

On the one hand, we are told, natural gas prices are currently above market-clearing levels in "many markets." 28/ On the other hand, we are told, freezing the price of old gas protects the consumers from price increases "while providing incentives necessary for secure, long-term gas supplies." 29/

Those principles clash head on. We can't have it both ways. If an "incentive" rate is to be offered, then it can be expected to be above market-clearing levels. That is exactly what happened under the NGPA. The cheap price-controlled gas was used as a cushion to bid up the price of "incentive" categories. Twenty cent gas subsidizes $10 gas, with the producer providing the subsidy.

If one believes that new gas supply is dependent upon a price above market-clearing levels, how will a future supply be obtained? Well, the scheme is apparent in S. 689. First, the NGPA promised an incentive price, funded by the producers suffering mandated low prices on most of their gas. The producers responded by bringing on much incentive priced gas. Next, S. 689 and other bills say, let's keep the gas found in the incentive categories and then renege on the incentive prices. Then, we will promise that, next time, if the producers respond to new incentives, the producer can keep the incentive prices. Who knows, all producers may not be able to see through this scheme. But we can.

28/ Section 101(3) of S. 689, 129 Cong. Rec. S2136 (daily ed. March 3, 1983).

29/ 129 Cong. Rec. S2136 (daily ed. March 3, 1983) (Statement of Sen. Heinz).

Conclusion

Re-regulation bills will lead us back into curtailments, if history teaches us anything at all.

Partial fixes will only lead to the demand for further partial fixes, as the NGPA has demonstrated.

A comprehensive bill leading equitably to termination of federal controls over price, contract terms, and over competition offers the best help for orderly gas markets. We will work with you for such a bill.

Thank you for allowing us to be heard.

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MEMBER COMPANIES

American Quasar Petroleum Company
Champlin Petroleum Company
Energetics, Inc.
Equity Oil Company
Grace Petroleum Corporation
Hunt Oil Company
Inexco Oil Company
Mesa Petroleum Company
Mountain Fuel Supply Company
Pennzoil Company
Pogo Producing Company
Quaker State Oil Refining Corp.
Sabine Corporation
Santa Fe Energy Company
Sinclair Oil Corporation
Southdown, Inc.
Southland Royalty Company
Superior Oil Company
Tenneco Oil Company
Terra Resources, Inc.

The CHAIRMAN. Thank you very much.

Senator Ford?

Senator FORD. You surprised me, Mr. Chairman. I was trying to get my thoughts together. You are not ready?

The CHAIRMAN. Do you want me to start firing?

Senator FORD. It is like a photographer was told, if my eyes are open and my mouth shut, send my wife a copy.

Let me start here. I have a question for you, Mr. Bush. You did not answer it the last time I asked you. I am looking for it now. That is the reason I was waiting a little bit.

Do each of you agree with the administration's prediction that the average price of natural gas will decrease in the first year the bill is effective?

Mr. BUSH. Senator, I think, without trying to predict prices which are pretty difficult to predict, in actual quantity, I can tell you that in today's market, if the bill were enacted right now, based on what new contract volumes are moving, where they are moving, they are moving at considerably below what is now considered section 102 price levels, so that if the gas capping mechanism were in effect as contemplated in the administration's bill, it would appear to me that yes, for the most part, there would be a significant reduction in prices.

I think that is what Mr. Barber referred to in the statement he made about the impact on producers. We are very much aware of that.

I might also quote to you though and something that Senator Nickles might be interested in, that I think——

Senator FORD. He is from a producing state. I am from a consuming state;

Mr. BUSH. I am going to talk about one of all our friends here. Yesterday or the day before in an Oklahoma newspaper, the largest distributor in the State of Oklahoma, the Oklahoma Natural Gas Company, made the following statement.

"If deregulation is enacted this year," and I do not necessarily think he was talking only about Secretary Hodel's proposal, "If deregulation is enacted this year, according to Charles Hughes," a distribution company, "residential gas bills within 3 to 6 months could be less or remain about the same. It is for certain they won't go up."

My friends in the distribution community always tell me they are the closest ones to the market and I would assume at that point that is pretty good testimony.

Senator FORD. Mr. Bush, why don't they come down today? Why is it that you keep putting it up to the cap and you blame the NGPA? That is a cap. That is not price. You can charge anything under that cap you want to.

Mr. BUSH. Yes, Senator, that is right. The problem is that with a large volume of 50 percent—I think we have had wonderful testimony today to the effect of why prices are in effect much above market clearing. The only way you can economically get a price being paid for new gas that is above market clearing is have the ability to roll it into a price that is significantly below market clearing. That is the only way you do it.

The way they have done it in NGPA——

Senator **Ford**. You are telling me that if you get a higher price, you have to have a lower price to move it in so it will be an average price that will not stick the consumer any harder?

Mr. **Bush**. I am not telling you that is what I want to do.

Senator **Ford**. That is what you just said, the economic way for high priced gas.

Mr. **Bush**. I am saying that the policy of the Natural Gas Policy Act was an effort to hold a large volume of gas forever regulated and thereby whether the intention was there or not, what happened was it gave an incentive for the purchasers of gas who were trying to buy new gas supplies to bid up that cost of gas that was available, resulting in Algeria LNG coming into the country at $7.50 a thousand cubic feet, exclusive of transportation, resulting in what we saw, exorbitant prices for some deep gas wells that were going at $7 or $8 or $9 and the market is now repudiating all that.

I am just saying that was an implicit result of the policy that we have been operating on. I am not advocating it.

Senator **Ford**. You are saying to me if we deregulate the old gas, the new gas will come down?

Mr. **Bush**. Yes, probably; that is right, sir.

Senator **Ford**. What will the average price then be?

Mr. **Bush**. Whatever the market will determine it is going to be.

Senator **Ford**. Whatever the market will bear is what you are getting now, is it not? That is where you are getting the rebellion.

Mr. **Bush**. No.

Senator **Ford**. I did not interrupt your thought process, did I, Mr. Bush?

Mr. **Bush**. I think you tried to get me to go down a road that I did not think I was necessarily trying to lead to here.

Senator **Ford**. That is right. That is the reason I am up here asking the questions.

Mr. **Bush**. I am trying to say, Senator, that where the market can determine a price in which all gas is competing against each other's form of gas, that the market will determine that as being a fair price.

Senator **Ford**. Mr. Bush, I ask you one simple question. Will the gas go up or will it go down?

Mr. **Bush**. I gave you my answer.

Senator **Ford**. You do not know?

Mr. **Bush**. In my estimation——

Senator **Ford**. Why do you want it deregulated then?

Mr. **Bush**. Senator, let me see if I can restate what I have just said and maybe I can make it clearer. I am trying to communicate to you——

Senator **Ford**. I am trying to communicate. I just want a yes or no on some of these.

Mr. **Bush**. They are not that easy. You can't always just say yes or no. Sometimes it is not communicative to say yes or no. I am just trying to explain what I believe.

I believe most people, most experts, most analysts, most people who are viewing the natural gas industry right now believe that if the market were competitive priced, as it was said in the Washington Post the other day, as it was noted, if the market were totally decontrolled, the price would be lower than it is today.

That is my answer. You asked me specifically could I tell you exactly what the price will be. No, I can't. I am saying that is based on what I know is going on the market it appears to be lower.

Senator FORD. Is the administration correct when they say that the price of natural gas will decline?

Mr. BUSH. Yes; that is what I am saying.

Senator FORD. It will decline?

Mr. BUSH. To the extent that everyone has the ability to analyze these things, some of us are less sanguine about predicting price behavior but for those people who are looking at the market conditions and feel that they have the expertise to evaluate those things, they say yes.

Senator FORD. The danger is that it will go up? There is a danger they will go up?

Mr. BUSH. It would be hard to see how with the mechanism of passthrough limitations on pipelines and the gas capping mechanism that is now constituted, it is hard to see how that could be the case. Theoretically I suppose the price could go up.

Senator FORD. All right, sir. What is your best estimate of what the new maximum lawful price for natural gas will be if the fuel cap provision in S. 615 is adopted?

Mr. BUSH. Again, I am treading a little bit on sensitive ground. I can't predict prices, as head of an association of producers. I am just saying that most people based on current market sales where gas is moving and a lot of gas is not selling right now, but where gas is being sold, it is averaging below the section 102 price.

There is gas moving between $2.70 and $3.20 a thousand cubic feet.

Senator FORD. Mr. Bush, let me ask you this question. Why isn't other gas below the cap price instead of new gas, since you have a glut and an overabundance of supply, why don't you reduce the price under the other categories?

Mr. BUSH. To the extent that the Canadians are unwilling to lower their price until we get our act together on gas, that is one reason. To the extent that the Algerians are unwilling to, as long as we are allowing people to roll in prices and average them, I think that might be a reason. To the extent that a domestic producer is faced with an inability to sell gas, he is probably entering into renegotiations on price with pipelines where that is a problem, but he has to do that, Senator, as you know, trying to make an honest evaluation to tell his royalty owners who he has a legal responsibility toward, that he can legally reduce that price confronted with pipelines which are buying gas at higher prices, perhaps in the same field.

Senator FORD. Mr. Bush, what would the price be if only new contracts and not renegotiated contracts are included?

Mr. BUSH. I would guess that it would be somewhere and again, without trying to predict the price, my guess is that it would approximate a closer new volume of gas that would be sold and as I said, in the intrastate market, in contracts that are now published where there are published numbers, the averaging is anywhere from $2.90 to $3.20 today in current thousand cubic feet numbers.

Senator **Ford**. Since you mentioned intrastate, are we going back to the dual market of intra and interstate problems we had prior to 1977?

Mr. **Bush**. I hope not.

Senator **Ford**. But are we?

Mr. **Bush**. No, I think to the extent that this legislation would attempt to get us out of the problems of regulatory or the regulatory mess that has overlayed the producing industry, I would say no.

Senator, if you are saying that only FERC applies to interstates and the intras would not have the applicability of that, the States are very willing and as a Governor, you know the States are very willing——

Senator **Ford**. They are all producing States, Mr. Bush.

Mr. **Bush**. If they are willing to pay—they are also consuming States, Senator, the highest consuming States of natural gas. They have the largest number of consumers, the most voluminous consumers of natural gas in the Nation.

Senator **Ford**. They have had it all along. That is the reason, 98 percent of all the utilities in Oklahoma are fired by gas. I understand that, that makes them a large consumer.

Are we on the dual track again of intra and interstate markets?

Mr. **Bush**. I don't believe so, Senator.

Senator **Ford**. That's fine. If the passthrough limitation in S. 615 is adopted, how would you expect the prepayments you are contractually entitled to collect from a purchaser which could not be recovered by a pipeline through the PGA mechanism—my time is up but answer that one.

Mr. **Bush**. Could you repeat it? I had a hard time following the question, Senator.

Senator **Ford**. If you prepay a producer, how do you get it back? If you are limited, if the rate is not improved.

Mr. **Bush**. You refund it. The producer would refund.

Senator **Ford**. How would you get it back from the producer?

Mr. **Bush**. Maybe Mr. Barber can help.

Senator **Ford**. I rest my case, Mr. Chairman.

The **Chairman**. Senator Hecht?

Senator **Hecht**. I have no questions.

The **Chairman**. Senator Murkowski?

Senator **Murkowski**. I have one question, Mr. Chairman.

We recall the chronic gas shortages of the 1960's and 1970's and accumulated in severe shortages I believe in the winter of 1967 or 1966, thereabouts.

In your opinion, and I would ask the panel this question, if Congress fails to address the natural gas problem at this time and we do not provide some type of legislation or some scale of deregulation, what is your estimate of the prospects of gas shortages in the future similar to those that we experienced in the 1960's and 1970's?

Mr. **Barber**. Senator Murkowski, could I give Mr. Bush a rest and try at that?

Senator **Murkowski**. Mr. Barber.

Mr. **Barber**. I happen to share Senator Ford's view and the Canadians that if we do not do something about the mess we are in, we are going to have shortages here again and probably by the mid-1980's.

Senator MURKOWSKI. Mr. Trout?

Mr. TROUT. Mr. Murkowski, we have about approximately 8 years of supply of reserves at the current rates of use. Normally in America we have had something between 11 to 14 years of reserves of gas.

I am not concerned about shortages as long as there is incentive to drill new gas wells, even though in today's world, the major part of America's gas use still comes—that is our domestic gas supply—from associated gas produced with oil.

We do need to drill the new gas wells to up our supply to a safer level than we have now. I think our answer is let America work, let free enterprise work. We think the market will react and gas will either go up or down depending on the market and the supply available.

Senator MURKOWSKI. My question is your prediction of whether we are setting ourselves up for a shortage in the future or not.

Mr. TROUT. I think under the President's proposal, we are not setting ourselves up for a shortage, no, because over the period between now and January 1, 1986, my understanding is that when we come out of this 90-day rollover provision and go to 3 years, the January 1, 1986, the best guesses I have heard is we will come out with something like $3 a barrel.

Senator MURKOWSKI. If you do not have a form of deregulation?

Mr. TROUT. If we do not have a form of deregulation? Then I think our supply of available natural gas will slip like it has slipped since 1977. In other words, 1977 was a shortage, we got into the——

Senator MURKOWSKI. You think we will have a repeat of what we had in the seventies?

Mr. TROUT. No, I do not under this bill.

Senator MURKOWSKI. No, if the bill is not passed and we do not have some type of relief.

Mr. TROUT. I think we have to have deregulation.

Senator MURKOWSKI. Mr. Bush?

Mr. BUSH. Senator, I will just observe, we have depleted our inventories about 42 percent of natural gas years of 14 years. It has been a steady erosion. Some people note that the Natural Gas Policy Act increased reserve adds recently. That is subject to some debate about whether or not the statistical category of provisions and corrections was really the predominant category at that point. Without getting into that, I think the supply or the supply threat is a real one, that we have to put the incentives in order.

I would also say that it is very, very important that the incentives be rational and economic right now. It does not do any good to find lots of gas reserves that are uneconomic to the market.

Senator MURKOWSKI. It was kind of my intention to ask you the same question I asked the others. I am specifically interested on what your estimate is of the prospects of a gas shortage in the future if there is not some form of deregulation passed.

Mr. BUSH. I think if you continue the present policy, I think supply shortages are very possible and very likely.

Senator MURKOWSKI. Mr. Chairman, I can only deduce that this particular group of panelists represents the major producers of this Nation, the intermediate producers and the small independent producers of gas.

From their testimony I gather that they are stating that there is not the necessary inducement on behalf of the producers of gas in this Nation to insure that without some type of legislation, this country will not be faced with the threat of some type of gas shortage within a given period of time which is not necessarily I think significant in determining time but the reality that we have this exposure and that you people speak uniformly for the producers.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Thank you, Mr. Chairman.

I would like to just pursue Senator Murkowski's line of questioning for a moment so that we are clear on what the effect of deregulation of the old gas is.

Why would the deregulation of the old gas increase production of new gas?

Mr. Bush?

Mr. BUSH. Senator, I think it ought to be looked at this way. First of all, I disagree with your evaluation that there is not additional gas to be found out of what you call old gas reservoirs. Forever regulated gas under the Natural Gas Policy Act covers more than section 104 of the volumes. It also goes into many other categories.

The critical issue is it is old only because it was declared by Congress prior to 1977 to be old. Many of those reservoirs have wells that have not yet been drilled that will still be regulated.

You are going to get—in fact we have a supply model that at one point earlier in this debate was estimating that we could get as much as 6 trillion cubic feet of additional gas reserves out of so-called section 104 gas through the balance of this decade if it were totally decontrolled, phased in total decontrol.

Senator HEINZ. Just to put that in perspective, how much more is that—how much more flow would that result in?

Mr. BUSH. First of all, it was over Natural Gas Policy Act and it was included in a volume that we said was 26 trillion cubic feet of additional gas overall, over Natural Gas Policy Act.

Let me address what I think may be bothering you more and your question led up to it, if you raise the price of old and you lower the price of new, what you do is you do away with an awful lot of distortions and inequities and what we hope will occur and what I think we can be quite competent will occur is that the proper incentive price will come from the marketplace and it will use more gas. You will get the proper price. The market will set the price and the demand for all gas will go up.

Industrial users will set the price. In economic theory, as you know, Senator, you cannot drive the price too low because the demand grows for the product and then the price goes up and the incentives are in the proper order.

What we have now, Senator, is what you complain about, by keeping the price of forever regulated gas controlled, it is like you cannot have it both ways. You can't complain about extraordinarily high prices that are created by keeping a large body of gas forever regulated, giving this ability to roll in Algerian and Canadian and at the same time worrying about keeping that control and then picking the exact incentive price that will elicit the amount of production you need to meet a demand, you can't predict.

Senator HEINZ. Let me——

Mr. BARBER. Senator Heinz, can I try to answer that question on behalf of my company and the people we represent?

Senator HEINZ. Don't take too long because I have some other questions.

Mr. BARBER. I won't; I will be very brief.

It is a question of money. The theory of the NGPA was that you had to hold the price of what we had down in order to get the specific categories that Congress determined they wanted drilled. That was the theory of the NGPA.

The theory about deregulating old gas today very simply put is that we have to spend money to find gas. If we have revenues available from whatever category of gas, that is revenue that is available to look for gas and we will quit looking for specific categories and start looking for gas, and that will be a healthy thing for us and a healthy thing for the consumer.

Senator HEINZ. One alternative analysis of what you say is we have a surplus of gas right now. Five years ago we were despairing of not having enough gas, and I think you can argue despite some of the distortions that clearly take place which may have taken place because of poor pipeline purchasing decisions, which may have taken place because of some very unwise provisions written into contracts, that had it not been for some very poor marketplace decisions with the benefit of hindsight, by pipelines, that nonetheless the NGPA in fact has dramatically increased supplies and indeed has brought about a glut.

Let me ask this. Mr. Bush, you said you thought in answer to a question to Senator Ford, that prices will decline if S. 615 is enacted. Do you believe that gas prices will decline if we took out, and I am not proposing this, if we took out the provisions that the President has proposed, namely, the take-or-pay limit, the limitations on price escalators, the passthrough limitations, and the market-out provision.

Would you believe if the administration bill was stripped of those contract-limiting provisions that the price of gas would go down?

Mr. BUSH. Senator, I have no way of pulling that answer right out. I think if you decontrol totally right now, if you totally decontrolled the price of all gas right now, if our distributor friends are right and we are at market clearing, the price cannot go up. It is economically impossible. The price cannot go up. Some prices will come down. Some prices will go up. If the price is at market clearing, it cannot go up.

Senator HEINZ. What if it is locked in by contracts?

Mr. BUSH. What happens under that, if a buyer cannot buy and a seller can't sell, they get together and renegotiate the contract. It is in the interest of a seller——

Senator HEINZ. Why isn't that happening now?

Mr. **Bush**. It is. There are people renegotiating contracts on a very daily basis and trying to do it, but let me comment on what you said earlier that is very relevant.

It would be awful tempting to sit here and probably try to get into the game of kicking around pipelines or at least saying they made bad marketplace decisions, but that isn't—Senator, this industry from the burner tip to the wellhead has tried to operate under the policies that have been written by this Congress for 30 years, and it has not done very well.

We have all made mistakes, because the policy's been flawed and it has been terribly flawed from time to time.

The pipelines——

Senator **Heinz**. You made that point earlier.

Mr. **Bush**. I want to reinforce it.

Senator **Heinz**. There is some information I need to get.

Mr. Barber, the administration has proposed limiting take-or-pay contracts to 70 percent. Do you oppose that?

Mr. **Barber**. Do I oppose the take-or-pay limitations?

Senator **Heinz**. Yes.

Mr. **Barber**. No, I frankly do. I think part of the problem with what you are dealing with up here is averages. When you look at an average wellhead price domestically in this country of $2.55, and what it was in relation to the same period 1 year ago, what you do not understand is that mixed changes by the pipelines, required by their take-or-pay problems, is rising the average price paid for gas, causing it to rise in a way that is not apparent by looking at the averages.

I think they need some help in this area and I support what the President is trying to do.

Senator **Heinz**. Can I just straighten something out then? You described my limitation on take-or-pay contracts of 50 percent as punitive yet you say 70 percent as opposed by the administration is fine. Why?

Mr. **Barber**. It is a question of judgment. I would not go as far as you have proposed to go, Senator.

Senator **Heinz**. It is funny that 70 percent would be terrific and 50 percent should be punitive. Would you think that is a little strong in your thinking?

Mr. **Barber**. I apologize. I would not say that 70 percent is terrific. I said I would support some take-or-pay reduction of the sort the President has suggested because the pipelines do have a problem in this area.

Senator **Heinz**. I guess my timer has not gone off yet. I am lucky.

Let's talk about area rate clauses. As you know, my legislation would seek to undo some of the decisions of the FERC. It depends when you measure the decisions by the FERC. The first time that people came in to get contracts which had been signed, since the NGPA went into effect, people signed contracts.

What they did was they went to the FERC and they said, Look, the ceiling price in this field is above the price we signed in this contract. First the FERC said by either a 4-to-1 or a 3-to-2 margin, the ceiling price does not entitle you, you have signed a contract, go up to the ceiling price, then a couple of people left the FERC and somebody changed their mind and the FERC voted the other way. The decision is now before a variety of legal authorities.

The result that the FERC allowed these contracts which had been signed to be renegotiated up to the ceiling price and my question is, why is it all right to have these contracts which were renegotiated up not be renegotiated back down?

Mr. **Barber**. I think there may be some misconception on your part, Senator Heinz, about what this area rate clause controversy is about. Area rate clause issue relates in large measure and I am not familiar with the precise situation you are talking about, in my company, the issue relates to the large numbers of contracts signed years ago when the FERC was setting the rate, and the only technique that was available for pricing your gas back in those days was an area rate clause which said whatever the FERC says is the maximum lawful price and by definition a just and reasonable rate under the Gas Act, you can collect under the contract.

The NGPA came along and there was some question raised by consumers about whether or not those clauses which had been entered into in good faith before the NGPA was passed, should operate on NGPA prices which had been stated by the Congress to be just and reasonable prices.

What will happen if your provision passes is that the whole pricing mechanism that has been in existence for years long before the NGPA was passed, will cause prices not to just go down to prior levels, it will cause in some cases those prices to go down to the last stated rate, which may be 5, 10, 15 cents.

You are going to save the consumer a whole lot more money than you have estimated if your provision passes.

Senator **Heinz**. Better not say that too loud. It might pass by acclamation. Thank you. Thank you, Mr. Chairman.

The **Chairman**. Senator Nickles.

Senator **Nickles**. Thank you, Mr. Chairman.

I was going to try and complete some of Senator Ford's questions. I will move on to a couple of other questions and if he comes back, I will try and talk about those because particularly on the intra and interstate, two levels or discrepancies between the two markets.

Mr. Trout, take-or-pay in the limitations—I will save that question for Senator Ford, too.

Let me just mention the cap. You represent a lot of producers. I think Senator Murkowski has said that all of you would agree that you would like to have some incentive for production but actually you might say independent producers would be losing some of their incentive for production under this bill, by your saying you want total decontrol.

NGPA has some incentive for production at the expense of regulating old gas. You are coming out in favor of decontrol so you are not really looking at any other incentive aside from the fact of allowing the marketplace to work. Is that correct?

Mr. **Trout**. As far as producers are concerned, yes. I personally feel and I think that most of our people feel that the least disruptive type of deregulation is the best type.

Senator NICKLES. You do not want to have several categories held down so that will encourage your activity in a particular place or field?

Mr. TROUT. Right.

Senator NICKLES. Mr. Bush, now that Senator Ford is back, this idea of a dual market or the intra/interstate, isn't it really a case of right now that we still have under NGPA a dual market in the fact that you have interstate pipelines because they have the "cushion" or the majority of the ownership of the old gas, that they have an advantage to where they can outcompete the intrastate markets, because they do not have that much of the "old" controlled gas and so they have an economic advantage through the roll in features of being able to purchase gas at higher than market rates where an intrastate company would not be able to do that, so you have quite a bit of a discrepancy between the two today?

Mr. BUSH. Yes, sir.

Senator NICKLES. You actually have a dual market today. If we move to total decontrol, say by January 1, 1986, wouldn't you in effect over a period of time be eliminating that dual market where there would be no economic advantage for inters versus intras or vice versa, whichever way you want to address it?

Mr. BUSH. Yes.

Senator NICKLES. I think it is important to know that. We have actually seen Oklahoma as an intrastate, we had an advantage when we were decontrolled and the inters were controlled, we had the advantage. When they put us under the system, we didn't have that low cost and now we are at a disadvantage.

We are not looking for an advantage or disadvantage. We are looking for everyone to be treated like or in a fair manner under the marketplace. I think that is important.

One other question, Mr. Bush. Senator Ford talked about the cap and how you can compute the cap. I would agree. I think all of your statements mentioned we needed to refigure the cap and have the cap really be new gas prices so we would be talking about new actual market price, not so much renegotiation, whether that renegotiation be old or whether that renegotiation be deep or LNG. Is that correct?

Mr. BUSH. That is correct.

Senator NICKLES. Doesn't the cap, even if we computed the cap as you are advocating and as myself and Senator Johnson and others will probably be working to change, that cap still, if the cap does anything, it is going to be saving money because it is actually NGPA or the lower and it is the lower of the cap or NGPA. The cap is going to be saving, if it does anything, it is going to be saving money down the line. It certainly cannot work the other way because NGPA prices would still be in effect if they were lower. Is that not correct?

If the cap is greater than NGPA prices, we will have zero effect. Isn't that correct?

Mr. BUSH. Yes.

Senator NICKLES. One other thing. Some persons might indicate—I have read some statements that will be coming up later—producers, if we deregulate old gas, producers will withhold that old gas. They will not renegotiate. They will withhold it and wait for some type of a shortage to force us into 107, force us into imports.

Could producers withhold the old gas? What would there be to prevent producers say from renegotiating those old contracts? Could you address that, any of you?

Mr. BARBER. I would be happy to, Senator.

Senator NICKLES. Mr. Barber.

Mr. BARBER. Anybody who advances seriously the notion that at January 1, 1985 we are going to shut everything in, doesn't know very much about the gas business. That is the only thing we have to sell and we have to sell it in order to stay in business.

Our problem today is takes, and in my detailed statement I pointed out that we have the capacity to run 600 million feet a day and we are running 180 million a day. We have to get this market straightened out so we can run what we have already found. If we are able to do that, then we will have the revenues to look for something new.

We cannot afford to shut it in. Our bankers would not let us.

Senator NICKLES. Is it a cash flow demand?

Mr. BARBER. It is a cash flow problem. You cannot stay in business and not sell your products.

Senator NICKLES. Mr. Trout, what about independents? Is that a similar response for independent producers, not quite as big as Pennzoil?

Mr. TROUT. There is about 3 trillion cubic feet of gas that is not even in a market today; A lot of independents own some of that. We would like to get that into the market for cash flow reasons as well as other reasons.

We are no different than the others except we produce smaller volumes. We rely on markets for cash flow of gas.

Senator NICKLES. Wouldn't the deregulation of old gas encourage the development of old gas instead of limiting that production and encouraging imports, high priced imports, high priced 107?

Mr. TROUT. Certainly, it would.

Senator NICKLES. Wouldn't that be beneficial to consumers? Wouldn't that help find this market level and give consumers a product that would be more economical than what we have by holding down one and actually encouraging the imports, encouraging paying the Mexican Government, encouraging paying the Canadian Government and encouraging payment of money to Algeria and other exporting countries?

Mr. TROUT. Yes.

Senator NICKLES. It seems like our current philosophy is shooting our own domestic industry in the foot and shooting our own consumers in the foot and exporting our consumers' dollars overseas which does not really make a lot of sense.

Mr. TROUT. We agree.

Senator FORD. Mr. Chairman, I understand the distinguished Senator from Oklahoma was looking for me and they came back there and brought me in here. Do you have some questions of me?

Senator NICKLES. No.

Senator FORD. I was just sitting here ready.

Senator Nickles. I wanted to clarify a little more on the intra-interstate discrepancies.

Senator Ford. I would be glad to get into that if you want to.

Senator Nickles. I think the questions were answered.

Senator Ford. I would like to get two points on it. You get their side to answer, the producing States, and you want to get my side, the consuming States. You mentioned my name.

The reason intrastates will have it so much better is they will have no Federal controls over them, number one. Two, under this bill, you would be allowed to cancel your contracts and break it and put it intra.

There are two reasons very clearly that why you will have a dual system, intra and inter. If I am wrong, everybody can explain it to me. The way I understand it is there will not be Federal controls on States, gets back into intrastate, the producers can break their contracts, put it right back into intrastate, we are back into dual contracts.

Then a section which allows contracts to be deregulated under existing law is the one responsible for the bidding disparity and it was crafted by the producing States.

I was here and went through it and stayed until 2 or 3 in the morning, missed Christmas parties and voted on Christmas eve for a turkey.

Senator Nickles. Mr. Chairman, I might again kind of repeat maybe my earlier comments that we have a dual market right now between intra and interstate.

We had a dual market prior to NGPA and we still have a dual market. We had unregulated or deregulated intrastates prior to NGPA.

Under NGPA we did regulate intras, but we found that the interstates, because they were under a regulated market, had a low cost—they had a lot of low cost gas.

They are able—and if you will look at the sheets of who is buying the high-priced gas, you will find it is not so much the intra; you will find it is mostly the inters because they roll it in or average it with the old regulated gas.

So we have a dual market right now. My statement is this: if we would move as rapidly or by January 1, 1986, if we totally deregulate all gas, that we would—eventually we would eliminate that dual market.

The dual market as it is right now works to the economic disadvantage of the States that have intrastate markets.

This is very much to our disadvantage, and we hope to see that eliminated and not try to have intras have an advantage over inters or vice-versa.

And I think that the only way that we could really do that is to have a totally deregulated market, which I think will benefit all 50 States and not single out a few individual producing States or vice-versa, the consuming States.

I have no other questions.

Senator Ford. May I ask the Senator from Oklahoma a question, Mr. Chairman, if I may at this point.

The Chairman. If the Senator from New Jersey doesn't mind waiting.

Senator FORD. Oh, he is 6 feet 4 inches, I will wait.

Senator BRADLEY. No. Mr. Chairman, I would be pleased to yield for the question.

Senator FORD. We are deregulating old gas. That is the low-priced gas. Let's look at two transmission lines or pipelines and say that one pipeline has *x* percentage which is high—we will just say 70 percent for hypothetical reasons——

Senator NICKLES. Of old gas?

Senator FORD. Old gas. And 30 percent of whatever you have: new gas or new, new gas or whatever. And it has done an excellent job of holding down the prices for their customers.

We have another pipeline or transmission line that reversed—only 30 percent old gas, 70 percent new or new, new gas, and then we deregulate.

What happens to the pipeline that has 70 percent old gas and you deregulate that on January 1, 1986, and to the pipeline that has only 30 percent of old gas?

Where do we go? How do you cope with that situation when—as it relates to management and profitability and service to customers?

Senator NICKLES. I would say that one that has that older or the greater percentage of old gas still has an economic advantage, but that will taper down very quickly, and so the marketplace, they are going to be on a fairly competitive level in a shorter period of time.

Senator FORD. So they move toward each other then?

Senator NICKLES. They would.

Senator FORD. And the fellow or the individual or the company or corporation that had the advantage up to now because of good management loses it because of this legislation.

Senator NICKLES. No, not necessarily. No, he had an advantage not by necessarily economics, but sometimes by fiat from Congress, which is not necessarily any great wisdom on their part or not——

Senator FORD. The wisdom to purchase and get a supply of old gas——

Senator NICKLES. What he might be doing is then you would see an increase of production of that old gas by all sectors and the consumers start to really benefit and not have a greater increase of imports, et cetera.

Senator FORD. Senator, he can't take any more than he is taking right now. I thank the chairman and thank the distinguished Senator from New Jersey for his patience.

Senator BRADLEY. I am always pleased to yield for a question from the Senator from Kentucky.

The **CHAIRMAN.** The Senator from New Jersey is recognized.

Senator BRADLEY. I would like to ask the panel a question somewhat similar to what Senator Ford was asking Senator Nickles.

It seems to me that as we talk about this piece of legislation and decontrol of natural gas prices, we always end up talking about the average national price.

And I think that the effect of the proposal on different regions is certainly quite different and on specific pipelines it is quite different.

So what I would like to ask is the panel's opinion that if we decontrol the old gas, what do you think will happen to the price of new gas, the gas that is now uncontrolled?

Mr. **Barber**. I think it has got to come down.

Senator **Bradley**. You think it will come down?

Mr. **Bush**. It will come down.

Mr. **Trout**. I think it has to come down, yes.

Senator **Bradley**. OK.

Mr. **Barber**. And if it doesn't, by renegotiation the bill contemplates that on January 1, 1985, the pipeline can just quit paying.

That is one of the problems Senator Ford has with the bill. If you are going to call kings *x* on everything on January 1, 1985, but the problem, Senator, is you have got to have a way to get from here to there, and that is what the bill is trying to work on.

Senator **Bradley**. Now let me ask you a second question. As Senator Ford asked, if a State happens to be buying from a pipeline that has a very high percent of new gas, what will happen to the price of that State's gas?

Mr. **Barber**. That is going to depend on some things besides his purchased gas cost because, as my prepared statement indicated, Senator Bradley, you get widely different results depending on what the attitude is locally about whether you use industrial gas for subsidized residential consumption or whether you load it over on the residential side in order to encourage industrial consumption.

Senator **Bradley**. But as it comes out of the pipeline.

Mr. **Barber**. As it comes out of the pipeline, what I think personally will happen is that the prices being paid at the wellhead for high-priced gas will come down and that prices that are being paid for low-priced gas will come up, but they won't come up as far as some of the members of this committee are worried about for two reasons: No. 1; if you look at the volumes and the price, you can't get all the old gas up to the average price being paid by bringing down all the high cost stuff.

There isn't enough high cost stuff there. You have got that problem. And on top of that, the President and the chairman have got some provisions written into this bill to just make sure that in case the free market doesn't bring the price down like the bill intends that it will, that there will be a regulatory restraint to see that it stays down.

If I have got a problem with the bill, it is that I think we are going to have so many locks on the door, the door is going to fall down.

Senator **Bradley**. So that you would argue that at the end of the pipeline, if the pipeline had primarily what is now decontrolled deep gas, it would end up with a drop in the price.

Is the converse of that also true: if you had a pipeline that had predominantly old gas, and you decontrolled the old gas, then in your view the price at the end of the pipeline would go up?

Mr. **Barber**. I think that can happen at the wellhead. But again for the reason I mentioned earlier, local rate design concerns and imports, whether the price that is paid in a particular area of the country goes up or down is going to be dependent on a lot of things besides what the producer gets at the wellhead because you can see that in the numbers today.

We are getting on an average $2.55 at the wellhead domestically. By the time you get the mix change issues that we have been talking about here and the imports into the picture, and you get local rate design issues into the picture, and you get the way in which the Federal Energy Regulatory Commission regulates interstate pipelines into the picture, what you pay for gas doesn't make any sense at all in relation to what we got for it at the wellhead.

Senator **Bradley**. Well, the implication is it is always a lot more; right?

Mr. **Barber**. Well, it is in some areas. Senator Ford, for example, is doing a good job in his State. They have got gas, at least for electric utility generation—they don't have a lot of it—but they have got it down around $3.95.

Now I don't know how they are doing that, but it is a lot cheaper than the $8 oil that is available in his State.

So it sort of depends on what your local attitude is about how you are going to handle the issue as between the residential and industrial consumer as a matter of local State regulation.

Senator **Bradley**. Do you agree with that, Mr. Bush?

Mr. **Bush**. I do and, Senator, I think it is interesting to note in New Jersey you have a tax on natural gas, on gross receipts tax, that adds a dollar to the burner tip price, while you don't have it on competing fuels that it has to compete against.

So there is a lot of things that local State governments have in the way of affecting the price that is realized by residential and industrial users and, you know, something we could have added to Governor Orr is a similar situation exists in Indiana and in the other States.

So there are other costs that are rolled in there, but I would agree with Mr. Barber's assessment.

Senator **Bradley**. I understand you can't totally ignore these other factors: imports, local regs, and the FERC pipeline regulations. But as a general propostion—let me just get a yes or a no—would you agree that new gas would drop; old gas would go up?

Mr. **Bush**. Yes.

Senator **Bradley**. OK; now let me take two examples. Let's take as the first that old gas decontrolled; and then a second situation that old gas decontrolled and an old gas tax imposed.

And let's say that tax was about 70 percent of the difference between controlled and market. All right? Let me ask you, would there be any significant difference in the decontrolled old gas price with an old gas tax?

See the two scenarios: one, you decontrol and price goes wherever the market takes it; the other, you decontrol and you have essentially an old gas tax on the difference between the controlled and market prices.

Mr. **Barber**. Is there any difference in what the pipeline is going to pay in those two scenarios?

Senator **Bradley**. No; is there any difference between the old gas price to the pipeline.

Mr. **Barber**. If your question is will the existence of the tax affect the market, I have to say I don't know. You could argue that it would not, and I would agree that it is an argument you could make, Senator, but I don't honestly know the answer.

Senator **Bradley**. Mr. Bush?

Mr. **Bush**. Well, I don't either. I just would point out, though, that the way in which in the President's proposal that old gas is treated, of course, is that there is no ramping to some kind of a market surrogate or some other prior formula schemes that have been used in others; it is basically under the belief that buyers and sellers will be renegotiating the contracts and that I would just say that there is going to be a lot of differential between where those prices are going to end up.

It is not going to be a quick and dirty or easy thing to do.

Senator **Bradley**. OK, but from your standpoint as producers, the imposition of the old gas tax would or would not affect drilling and exploration?

Mr. **Bush**. Well, any tax is going to act as a disincentive, Senator, it just does. You know, it has been proven by that—you know, the Federal Reserve Bank Study, Mrs. Leda's study in San Francisco that predicted the impact of the windfall profits tax on oil.

I think there is—taxes are disincentives to production and this tax would be a disincentive.

Mr. **Barber**. It is going to help us get to that scenario that Senator Ford and the Canadians were talking about, Senator Bradley, where we got shortages again because what you do with a windfall tax——

Senator **Bradley**. I am sorry; I didn't understand that. What?

Mr. **Barber**. I said if you put a windfall tax on old gas, it is going to help us get to that shortage situation that Senator Ford was talking about a lot quicker, for a very simple reason: you have got a situation where in any kind of transition, some people may gain, some people may lose, and you can concede Senator Nickles' point that maybe some of the people who have been getting above-market clearing levels are going to get less, and others who have been getting less are going to get more.

But what will happen under this bill is the total part available to producers is going to be smaller between now and January 1, 1986, without a tax.

If you put a tax on top of it, you are going to be in a situation where the producer is not going to have adequate revenues to look for domestic gas.

If you continue to let the imports come in in the way in which Senator Percy was talking about, you are going to further aggravate the problem.

Senator **Bradley**. Let me ask you this: If you didn't put a tax on, but you decontrolled old gas, do you think that might be a disincentive to new entrants to go out and look for oil?

I mean, the idea is that we have got to find new gas, right? We have got to find new gas. And if you have a tax, then everybody is starting with the basis of well, can you make money on what the market price is.

But if you don't put on the tax, then you have essentially given a benefit to the producer that has a lot of old gas and who will then have the windfall and the means to go out and look if he chooses.

But in the process, you discourage the new entrant. What is your reaction?

Mr. **Barber**. Well, all I can say is under the present situation the doctors and the lawyers and the dentists and the amateurs are getting out of the business, and there is not going to be anybody left but the people with some financial staying power.

You can pick it up almost on a daily basis and see something about a new producer that has just gone into reorganization or all the way into bankruptcy.

The industry is sick. And I don't see how putting a tax on it is going to help it get well.

Mr. **Bush**. And, Senator, even beyond that, you know, Mr. Trout and a number of the independent producers are suffering, you know, severely right now.

Those new gas—you know, we have all watched and seen the stories of the people who went out and chased the deepest gas around and had the biggest incentives and the market repudiated that price.

It just won't pay it. It said it wasn't worth it. And at that point the critical factor is if the market demands gas, if the price is right and the market is able to set it, you are going to have people getting into the business and trying to go discover gas to go sell it because the incentive will be there.

Senator **Bradley**. And you don't think that that will result in an indirect subsidy to those who have old gas?

Mr. **Bush**. Senator, there is a couple of facts that have been rolling around that I just think ought to be addressed.

You know, we are talking—you know, the Washington Post story that I think a lot of people read that talked about the top 20 big—you know, the heavy.

First of all, they reference now, we are not talking 4 or 5 we are talking top 20 producers supposedly owned, and the gas figure they use, that 70 percent number, is the Consumer Federation of America apparently sent some interns over for 2 or 3 months into FERC and they went through the thousands of sheets to try to discover ownership.

That is really the only record that anyone has of who owns what category of gas. It is in the public record, but it is a very difficult number to get at.

But it is almost irrelevant. There are 20 companies that own 50 percent of the gas. Ironically, of the deep gas production in 1981, the top 20 companies produced 48 percent of it.

So the fact of the matter is that, you know, where the story said well, the province of the deep gas thing is the province of largely the small independent producer.

It is wrong. Fifty percent of the deep gas was produced in 1981 by the same top 20 companies they say—the ownership of gas is a highly competitive—there are very few industries in this Nation, certainly none as mature as the oil and gas industry, where it takes as many companies to get to 50 percent, as it does.

Mr. **Barber**. Senator Bradley, we were named as one of those 20 companies, so let me make a brief comment directly on the points you are raising.

It may be a dubious honor to get added to that list, but fundamentally the way we look at it is that we have financed what has been going on in this country since 1978 with lower revenues from gas that we had developed prior to the enactment of that legislation.

To put it another way, we have had 100 percent tax on 104 for the last 5 years. Now we are going, and we have been financing some of those imports that Senator Percy and Senator Nickles have been talking about in the same way: by having our prices held down so you can afford to pay these exorbitant prices that are being paid in relation to what today's market clearing level is.

As we see it, if you put a tax on 104 in the process of getting through the transition to decontrol, we will have paid the tax twice.

We have paid it since 1978. We are going to pay it again.

Senator **Bradley**. Thank you.

Mr. **Trout**. Senator Bradley, may I say this, what you were saying about producers, independent producers particularly, it depends on the mix of old gas they got, really, whether it is going to bother them or not, but let's take producers in the Hugeton field.

The Hugeton field is one of the largest—has been one of the largest gas fields in the country, and it is all old gas.

For somebody that has only production in the Hugeton field, that is what he has got: it is all old. Whether it affects the producer or not depends on the mix.

The small producers, of course, have a lot of old gas, but they are small volume wells. I wanted to point out one other thing about independents at least.

Over the past 8 years, independents have spent 105 percent of their revenue, of their gross revenue, to put it back in the industry, and I think this would continue to develop and look broad.

And they have approximately 25 percent of the old gas. So I think this will continue.

The **Chairman**. Thank you, Senator Bradley. I have maybe just one question or at least one area I would like to explore that hasn't been fully explored by the previous questions.

It has been charged by some that the large producers of gas are also the large producers of oil, and that because they have associated oil to produce and to sell, that they are in a position to withhold from the market the gas which they have available for the market in ways that others could not do.

Now would you respond to that, Mr. Bush?

Mr. **Bush**. Senator, I know you don't ascribe to these theories, and I just hope you don't. I think anybody who would believe that in the number of companies that are in this industry and as competitive as they are—it is one of the most competitive industries in the United States—could possibly imagine some kind of collusion existing or be successful in that kind of a collusion where there are people competing to sell gas under the strict antitrust laws.

Every time this charge has come up in the past, when we went through this all during the oil problems, there has been numerous Government studies—Chairman Perchuck's Federal Trade Commission that looked into this, the Department of Justice under the

Carter administration—repudiated any possibility that that kind of collusive activity could or would exist in the oil and gas industry.

And if you need real life experience, look at 13 nations right now meeting in London outside the scope of any antitrust laws whatsoever trying to cartelize the parice and doing so with a great deal of unsuccess.

The **Chairman**. I am not so much directing the question towards collusive action as I am independent action by several of the companies that might, because they maintain cash flow—Mr. Barber, you mentioned it would be impossible to withhold——

Mr. **Barber**. Yeah, I understood your question, and that is not a practical alternative, certainly not in our company because we are very gas prone.

But even if we had a roughly equal mix between oil and gas, we need to sell as much of both of those as we can to keep ourselves in good financial condition and to keep ourselves in shape to get on with our business.

We do not have the alternative to quit producing gas because we have got a little oil production.

The **Chairman**. Mr. Trout.

Mr. **Trout**. Senator McClure, let me say as a practical physical matter when you produce associated gas with oil, you basically have got to do one of two things with it: you either have to sell it or put it back on the ground because you can't flare it any more.

So your question was addressed to the associated gas companies produced. They have to put it back in the ground through injections or sell it, one of the two.

The only other thing they could possibly do with it is run it through a gasoline plant and strip it and then dry gas is sold.

The **Chairman**. Let's assume for a moment that it is not associated gas; just from an integrated producer who produces both oil and gas, generates cash flow from the sale of oil and can withhold from the market the gas that he produces because he has sufficient cash flow from the sale of oil.

Is that a realistic threat?

Mr. **Trout**. No, I really don't think it is. I really don't.

The **Chairman**. Gentlemen, thank you very much.

Senator **Ford**. Mr. Chairman, I want to make a point before the panel gets away, and I want to thank Mr. Bush for some points that he made.

You gave me some figures I have been trying to secure and only heard them just a few moments ago, and I just want to make a point here and not a question, that the 20 majors own 50 percent of the low-cost gas:

Mr. **Bush**. No, no, no.

Senator **Ford**. Wait 1 minute:

Mr. **Bush**. No, that is not right, Senator.

Senator **Ford**. Well, OK, they own 50 percent of the high-cost gas and 48 percent of the low-cost gas. Is that what you said?

Mr. **Bush**. What I said was that of the 1981 production of deep gas, 48 percent of it came from the top 20 producers. That is correct.

That includes, of course, one pipeline and many medium sized companies.

Senator **Ford**. That is right. And then they own a great deal or a large percentage of low-cost gas. So it appears to me, Mr. Chairman, that those that have the high-cost gas, roughly 50 percent of it, 20 companies, also own a major part of the low-cost gas.

They can afford to have the high-cost gas come down because the low-cost gas is going up, and they then hit the market, where those other 52 percent or 50 percent owning the high-cost gas with no low-cost gas are stuck.

Mr. **Barber**. Mr. Chairman, since we were listed as one of those 20, I would like to make sure the record is clear.

Senator **Ford**. I have not read all 20, and I am glad you stepped forward.

Mr. **Barber**. I would like to make sure the record is clear on what our situation is. We, although we are one of the 20 largest gas producers in the country, Senator Ford.

Only 5 percent of our mix is high-cost gas. So we have got a much more serious problem than some of the other top 20, for example, in trying to get our gas prices up because we don't have enough in our mix to negotiate down.

Senator **Ford**. Well, you are one of those that will be stuck under this scenario.

Mr. **Barber**. Well, I don't know that I would agree with the word "stuck," but what I will say is we are going to have less revenues around than some of the people who have been running these projections may think.

Senator **Ford**. OK, thank you, Mr. Chairman.

The **Chairman**. Thank you very much, gentlemen.

Senator **Warner**. Mr. Chairman, if I could ask——

The **Chairman**. Oh, Senator Warner, excuse me.

Senator **Warner**. Forgive me, Mr. Chairman, we have our Armed Services Committee meeting. The question I would put to the panel, purely on a voluntary basis if you wish to answer it, do you think that we would have to incorporate in any legislation a fuel assistance program, the purpose being to try and diffuse this issue of conflict in policy and the social problems connected with the low-income person who just simply cannot pay a higher bill?

The question again is, Would you support as a part of this legislation a section on a fuel assistance program?

Mr. **Barber**. Senator Warner, I have been told, although I don't know that this is true myself, that there is enough fuel assistance on the book to hold most consumers in this country who are in need of fuel assistance to the prices they were paying 2 or 3 years ago for gas.

But if that is not true and additional legislation in this area is needed, we would support such legislation.

Senator **Warner**. Well, in the fall when we took a quick look at this issue, this committee came up with a brief fuel assistance program that helped at that time. Any other comments?

Mr. **Trout**. Well, I would say I would support that if it is needed, as long as it didn't create a tax on the gas.

Senator **Warner**. That is clear.

Mr. **Bush**. Senator, I just would comment that we would support that. We have stated that it wasn't the time to cut low-energy income assistance at this point.

But I just would want to make the further note that, to a certain extent, your comment is predicated on the fact that decontrol would bring higher prices, and I would maintain that decontrol would bring lower prices to consumers.

Senator **Warner**. Well, maybe we could have a trigger in there. It would only come into being if, in fact, there were higher prices. Thank you very much.

The **Chairman**. Thank you again, gentlemen. Again I will remind members of the committee as well that we still have two panels to hear from.

We have now heard from 6 witnesses and we have 10 to go.

Mr. **Trout**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, gentlemen. We will next hear from a panel, Mr. Gary Dage, Independent Gas Producers Committee, Ms. Britann Wallace, chairman of the Natural Gas Committee, the Independent Petroleum Association of Mountain States, Mr. Rex Fuller, chairman of the National Energy Policy Committee and Texas Independent Producers and Royalty Owners, Mr. John McMillian, Northwest Energy Company, and Mr. David W. Wilson, president of the Coalition for Equal Access.

Again I will remind those who are members of the panel that we will place all of your prepared statements in the record in full and will ask you to limit your summary of those statements to 5 minutes.

Then we will proceed to the questioning again under the 10-minute rule for the members of the committee. And I might indicate for the record and for you for just a moment that I have to go over to the floor for a matter that will take just a few minutes.

I don't indicate any lack of interest in your statements. I will be back before you finish your statements, I suspect, and we will proceed from that point.

With that, Mr. Dage, you are on first.

Mr. **Dage**. Thank you, Mr. Chairman.

STATEMENT OF GARY DAGE, VICE PRESIDENT, GHK GAS CORP., ON BEHALF OF THE INDEPENDENT GAS PRODUCERS COMMITTEE

Mr. **Dage**. Thank you, Mr. Chairman. My name is Gary Dage. I am vice president of GHK Gas Corp., headquartered in Oklahoma City, Okla.

I want to apologize to the committee for the absence of Robert Hefner, our company president, who was scheduled to present testimony today in behalf of GHK and the Independent Gas Producers Committee.

Mr. Hefner was unavoidably detained in Oklahoma City on company business. I am sure he would have made a great deal more exciting witness than I because he is eminently more qualified to discuss this issue than I, having pioneered in the exploration and production of new natural gas at an Arco Basin in western Oklahoma.

Senator **Nickles**. Mr. Dage, could you pull the microphone a little bit closer?

Mr. **Dage**. Is that better?

Senator NICKLES. Yes, thank you.

Mr. DAGE. Mr. Chairman, the Independent Gas Producers Committee, of which GHK is a member and represents here today, consists of approximately 15 companies who have invested since 1978 somewhere in the neighborhood of $5 billion in the exploration and production of new natural gas in the United States.

You have heard today from people who are at all levels of exploration in natural gas and oil. You are going to hear diametrically opposed interests among producer organizations because we have diametrically opposed views of the proposed legislation.

GHK, the company I represent, is in the natural gas exploration business. Ninety-nine percent of our investment is in exploration for natural gas.

Ninety-five percent of our revenues come from natural gas production. Ninety-seven percent of our gas reserves are new gas split about equally between gas below 15,000 feet and gas above 15,000 feet.

The panel before, that just appeared before you, was made up primarily of oil producers. They are not in the natural gas producing business.

Because of that, I would suggest to the committee that to each producer witness who appears before you you should ask several questions that I think will be of benefit.

First you should ask what share of your investment is in oil versus your share of investment in natural gas. What share of revenues do you derive from oil versus your revenues from natural gas.

And, lastly, how much new gas versus how much old gas do you own.

We have read recently in the press—and this has been verified by the Chairman of the FERC—70 to 80 percent of the old gas reserves in the United States are owned by 20 percent—20 major companies.

Seventy-five to eightly percent of the new gas reserves are owned by independents. Based on this meld of gas, if the old gas prices are decontrolled, each $1 increase in old gas prices will equal roughly $100 billion in new assets for the majors at the expense of independent gas producers.

Put another way, each $1 increase in old gas price will equal roughly $8 billion annually in revenues transferred from independents to the majors.

This brings me to the administration bill. First, while it does deregulate or decontrol the price of old gas, it is, in fact, a reregulation bill.

It would roll back the price of new shallow gas by as much as one-third; it would provide less incentive to drill for new gas than the 1938 Natural Gas Act.

Consider this: Before NGPA, producers in Oklahoma received $1.80 for newly found gas, which yields $2.60 in 1983 dollars.

The most producers could hope to get under the Hodel bill is around $2.25—almost 20 percent less in real dollars than in 1977 when lack of drilling incentives led to widespread shortages, plant closings, and worker layoffs.

There are several examples of recontrol in the Hodel bill. First, there is a moratorium on purchased gas adjustment increases which establish a set price for gas.

There is a cap on gas under existing contracts. This could force a price rollback to as low as $2. Independent companies such as GHK and others can't survive in the exploration for new natural gas reserves with that price.

Our investors and commercial lenders have relied upon our contracts for collateral. If this provision were passed, why would anyone ever again invest in independent drilling.

The bill would also reregulate section 107 or deep gas. Prices for newly found gas, because of the moratorium on pipeline passthrough, any increase in purchased gas cost would fall to about $2.25.

I see that I have run out of time. I have not run out of anything to say, but I will try to conclude by saying that our main concern about the Hodel bill is that it will reduce the incentive to explore and produce new gas reserves.

We have replaced reserves by 114 percent of production in the last year. We have been successful in bringing on new supplies, prices are coming down.

They dropped .08 percent in December, 2.7 percent in January. Pipelines have exercised market-outs in their contracts.

Independents are voluntarily renegotiating contracts because we cannot survive without cash flow, and we would hope that you gentlemen will enact legislation that will give our industry, which is a new industry since 1978, an opportunity to survive and to continue to produce the supplies of natural gas that are there and that will carry us through to the 21st century.

Thank you very much.

[The prepared statement of Mr. Hefner follows:]

STATEMENT OF ROBERT A. HEFNER III, PRESIDENT AND MANAGING PARTNER, GHK GAS CORP., ON BEHALF OF THE INDEPENDENT GAS PRODUCERS COMMITTEE

Introduction

Mr. Chairman, my name is Robert A. Hefner, III. I am President and Managing Partner of the GHK Companies, headquartered in Oklahoma City, Oklahoma. I am here today representing both GHK and the Independent Gas Producers Committee (IGPC). IGPC is composed of 15 active new gas drilling companies, located in Oklahoma, Texas, Kansas and Louisiana. A full list of IGPC member companies appears at the conclusion of my prepared statement.[1] To give you an idea of the magnitude of the drilling effort represented by IGPC, we are fewer than two dozen out of the thousands of companies represented on this panel. Yet our few companies have spent and/or raised almost $5 billion in the exploration and development of new natural gas supplies since 1978. These statistics reveal two things. First that a relatively small number of independents account for a massive share of the natural gas drilling activity undertaken in recent years, and second, that a large number of companies including majors and oil oriented independents are not primarily in the business of looking for natural gas.

It has been 15 months since this committee met to consider implementation of the Natural Gas Policy Act (NGPA). Now, as before, you will hear two distinct points of view from two distinct groups within the producing community. The first are those associations representing companies whose corporate fixed investment and annual revenues are weighted overwhelmingly toward oil. Let me recall what they told you in November 1981. They testified:

-- First, that natural gas prices were rising too slowly in relation to oil. The Domestic Petroleum Council said "The escalation provided in the NGPA will not afford a means for the new natural gas price to catch up with the price of crude oil by 1985."[2]

-- Second, that natural gas drilling activity was lagging in relation to oil. The Natural Gas Supply Association argued, "While gas well drilling reflected a sharp surge during the decade of the '70's in response to increased economic incentives, it is now apparent that the momentum of the early '70's has been lost following the passage of the NGPA and decontrol of crude oil prices."[3]

- -- Third, that unless action were taken to raise the wellhead price of natural gas, shortages could begin to appear as early as 1985. The IPAA said, "We believe that if this relative (post NGPA) trend is allowed to continue; we can expect to see a return to shortages by the mid to late 1980's."[4]

The second group, and the one I speak for here today, is composed of companies that are primarily in the business of discovering and developing supplies of natural gas. Let me repeat what we said to you:

- -- First, that gas prices were increasing more rapidly than was commonly appreciated; indeed, that prices could not continue to rise as rapidly as they had since 1978 without overshooting market clearing levels.[5]
- -- Second, that strong incentives to drill for natural gas were turning around what had once been considered a bleak outlook for future supplies, with record numbers of wells being drilled and a vast improvement in additions to proven reserves. Although more stripper oil wells, each producing ten barrels per day or less, were being drilled, significantly more natural gas was being found.[6]
- -- Third, we agreed that a cloud was hanging over the market, but the problem was not lack of supply. The problem was lack of demand.[7] In today's market greater demand means lower consumer prices, since the fixed costs of our nation's $100 billion pipeline and distribution system can be spread among a larger pool of users.

I suspect most of the other witnesses before you will offer a different point of view than mine. I respectfully urge that you reflect, not only upon who is in the majority of witnesses here, but also upon who has the most direct experience and the best track record for accuracy in discussing the state of natural gas markets.

Financial Condition of Gas Exploration Companies

Mr. Chairman, I flew to Washington late last night after working on the documents confirming a refinancing plan that will permit my company to work out of a serious liquidity problem, triggered by falling gas prices and the collapse of the Penn Square Bank. That work will continue until the plan is in effect. Many members of our industry, however, are not as fortunate as GHK. I make this point to emphasize to you the precarious condition of our industry. Nearly all active companies drilling for gas -- whether they drill shallow or deep -- are having severe problems raising capital to explore. We are not major companies, with the internal assets and cash flow to survive a 65 or 70% drop in prices -- to levels in real dollars 17% below where they stood when the NGPA was passed in 1978. Beware of well intentioned but exceedingly dangerous proposals that could destroy all of the progress the natural gas industry has made since the winter of 1977 when shortages forced plant closings and layoffs of a half million workers throughout the midwest.

If independent producers are driven out of business, the same multi-national companies that already own America's oil and coal supplies will soon dominate ownership of newly discovered gas reserves as well. Eventually the major companies will develop these reserves, but they will do so on a schedule that matches their own corporate economic interests and not on a schedule that matches the nation's interest in necessary development of the domestic gas alternative to imported oil.

The Natural Gas Consumer Regulatory Reform Act

Administration witnesses appeared before you earlier this week to discuss the bill recently submitted by the President. I am sure that the intentions of the President and Secretary Hodel are the best, but the proposal crafted by the Department of Energy would be a disaster for both current producers and users of natural gas. This measure has wrongly been called a deregulation bill. It is not. It is a reregulation bill which threatens to put our country on a path that will end in shortage by 1985 or 1986. It will destroy any incentive for private investors or commercial lenders to provide capital for new exploration. It will precipitate the rapid depletion of already discovered reserves. It will set the stage for a severe price jolt just as so-called consumer protection provisions are scheduled to expire. Given these economic realities and given the political realities that have caused the

Administration to put a new regulatory lid on NGPA decontrol, the Energy Department proposal will result in price controls in perpetuity not just on old, but on both old and new gas. After the lessons of the twin oil shocks of the 1970's, I am amazed that the Congress, and that this Committee in particular, could contemplate for a single moment the reregulation of new natural gas.

Let me explain, from the standpoint of a natural gas explorationist, what this bill would do.

First, the Act would prohibit pipelines from passing through to consumers any increase in purchased gas costs above inflation unless special circumstances are found to exist in a formal regulatory proceeding. This freeze on gas prices, in real terms, would be transmitted directly back to the wellhead. Recall that this is exactly the way our country became enmeshed in wellhead price controls in the first place, through a system of pipeline regulation established by the 1938 Natural Gas Act.

In reality the moratorium on PGA increases would not freeze, but rather would roll back new gas prices by as much as a third. Here's how the provision works. As of last fall, the average cost of domestic gas purchased by pipelines was $2.53.[8] Even if domestic wellhead prices remained constant, the shifting mix of gas, as older, lower cost reserves are depleted, will cause prices to equal or exceed the "inflation-only" standard for PGA increases. However, the bill also contemplates a significant increase in prices paid for pre-1977 flowing gas, which can only be accomodated by an offsetting reduction in prices for gas discovered since 1977.

This means it is likely most new gas contracts could be as low as $2.25. Recall that the NGPA authorized ceiling price for new shallow gas sold in March 1983 is $3.34.

In addition, the price for post-NGPA gas under existing contracts would be subject to a cap based on the average price of newly signed and renegotiated contracts. If, as we have just seen, the moratorium on PGA increases prevents new gas contracts from exceeding $2.25 per mcf, and old gas contracts are initially renegotiated upward from $.50 to $1.00 or even to $1.50, the gas cap would fall as low as $1.75 to $2.00 per mcf. The net effect of the cap would be to force producers to renegotiate post-1977 contracts downward to a level lower, in real terms, than we received for supplies discovered before the NGPA was passed -- less than $1.80 in constant dollars for pre-NGPA intrastate sales.[9]

Moreover, the Administration bill would reregulate the only category of natural gas which is now deregulated -- supplies discovered beneath 15,000 feet.

Mr. Chairman, the average price for newly found deep gas has fallen in the span of a single year from between $7.00 and $7.50 per mcf to an average of about $3.50 per mcf. For most contracts now being signed, and I regret to report only a few are being signed, there is no distinction between the price for gas found at 0 to 14,000 feet and the price for gas found below 15,000 feet. All newly discovered gas -- shallow and deep -- is effectively deregulated today. The moratorium on pipeline pass through of purchased gas costs would force Section 107 prices to the $2.25 level -- which would mean that drilling below 15,000 feet would cease. In every one of our nation's leading provinces -- the Midcontinent, the Permian Basin, the Western Overthrust, the Gulf Trends -- the majority of our nation's remaining reserves are to be found in sediments below 15,000 feet.[10]

The Administration bill would not only reregulate our prices through a disasterous roll back. At the same time, this proposal would effectively tear up our contracts. Theoretically, the measure allows producer-pipeline contracts to remain in effect until Janaury 1, 1985. In reality, producers would be forced to renegotiate immediately, since pipelines are in a position to impose a $2.00 lid on our prices. The cap could even be lower. The pipelines need only renegotiate a few old gas contracts upward from fifty cents to a dollar per mcf while they withhold, for a few months, the signature of any new gas contracts. Immediately our existing contracts become virtually worthless -- hypothetically our prices could drop below $2.00 if the transmission companies decide to press their advantage under the terms of the proposed bill.

Mr. Chairman, the NGPA is unquestionably a complex piece of legislation, but our industry has learned to live with it. The 1978 law has provided predictability without endless legal battles and regulatory delay. Imagine a system wherein producers must plan their drilling programs with prices to be determined through monthly averaging of thousands of contracts. What crystal ball can tell us how many contracts will be renegotiated in a particular month and under what terms? Our financial outlook on into the future will be dictated by pieces of paper accumulated by pipelines and Federal workers -- known only to them, not to us -- until the FERC releases the data which determine our revenues. How could we ever pursuade commercial or private lenders to invest in or lend to new drilling programs when prices will be determined by a system of "contract roulette?"

The irony of this situation is that if you were to ask the FERC right now to tell you the average price of gas under contracts signed in each of the last 15 months -- so that you would then have complete information upon which to make your own assessment of the current state and future outlook of natural gas markets, I predict it would take not weeks, but six months or more to get an answer. If you had that information, I know you would reach an inescapable conclusion: that prices for domestically purchased supplies have passed their peak; they are now falling and will continue to fall under the NGPA.

Natural Gas Prices Are Falling

Even without such data there is ample evidence, both empirical and anecdotal, that prices are coming down. In December 1982, the Bureau of Labor Statistics (BLS) reported a decline in the wholesale price of natural gas of 0.8 percent. In January 1983, BLS reported a 2.7 percent drop in wholesale gas prices. No one who closely monitors industry trends should be surprised that gas prices are falling. Energy trade journals have, for the last six months, highlighted case after case of downward revisions in gas prices. Copies of selected articles appear at Appendix B. Let me just highlight a few examples for you. Between January 21 and March 2, 1983, Energy Daily reported price reductions and/or exercise of market outs by the following pipelines: Lone Star Gas Company, Michigan Wisconsin Pipeline Company, Sun Co., and Northwest Central Pipeline Corp.[11]

Since October, Natural Gas Intelligence has reported price reductions and/or market outs by Channel Industries, Texas Eastern Transmission, Transwestern Pipeline Co., El Paso Pipeline Co., Panhandle Eastern, Houston Pipeline, and Mid Louisiana Gas Co. One pipeline -- United has twice exercised a market out on its Section 107 supplies.[12]

The March 8, 1983 issue of Oil and Gas Journal reveals six other pipelines -- Florida Gas, Natural Gas Pipeline Co., Northern Natural, Northwest Pipeline Co., Tennessee Gas Transmission and Palo Duro -- also exercised market outs.

As producers we are well aware of consumer anger over rising gas prices, which in some areas of the United States this last winter were projected to increase by as much as fifty percent. Chairman McClure pointed out last December in the debate over amendments to freeze prices and abrogate gas purchase contracts, the cause of those higher prices is emphatically not the NGPA. Senator McClure said the following:

> "Of the 95 cents increase (in residential prices between July 1981 and July 1982), only 39 cents was attributable to increased producer revenues. The other 56 cents was the result of increases in pipeline and distribution costs and the costs of LNG and gas imports. Of the 39 cents in additional revenues received by producers, only 10 cents to 17 cents would have been affected by a wellhead price freeze. The remainder of the increase in producer revenues, according to DOE studies, was caused by changes in the mix of gas taken by pipelines."[13]

Senator McClure was exactly right during the Senate debate on the price freeze legislation when he said:

> "A 2-year freeze on wellhead prices would have a devastating pyschological impact on all producers and a serious financial impact on many producers. In each case, the result would be a reduction in the financial incentive of producers to explore for and develop new gas supplies. A price freeze would deprive producers of the revenues they had anticipated when wells were drilled. Producers would then shy away from drilling because of fear of more federal intervention."[14]

Mr. Chairman, these justified fears about the impact of a freeze are mild compared with the impact of a roll back as proposed by the Administration.

Myths About the Natural Gas Industry

There are five great myths about the natural gas industry which, because they have been frequently repeated and by an apparent multiplicity of sources, are today commonly believed. The five myths are:

1. That unless the NGPA is changed gas prices are doomed to rise above the equivalent price of oil.
2. That drilling activity has shifted away from natural gas and toward oil.
3. That natural gas reserves have declined as a result of alleged flaws in the NGPA.
4. That because natural gas is overtaking the cost of residual fuel oil our markets are increasingly shifting to petroleum.
5. That old gas decontrol will lower consumer prices and increase the nation's gas supplies.

Let me respond to each of these in turn.

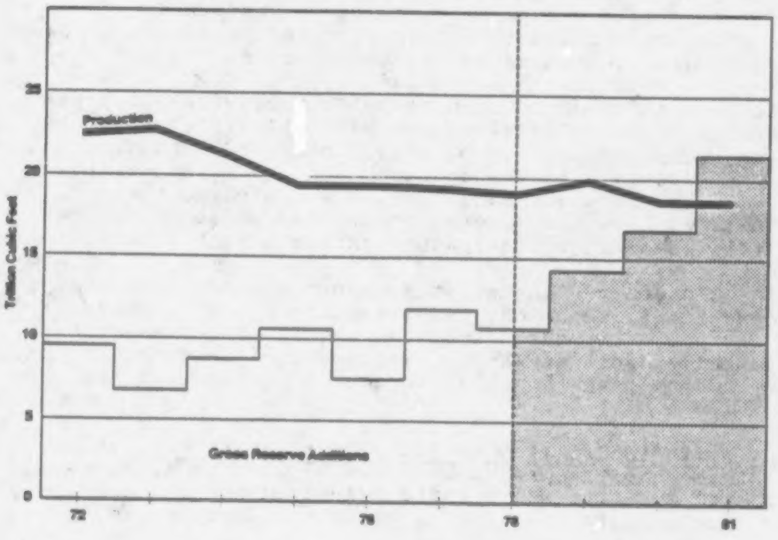
Prices. Despite predictons of infinitely rising domestic natural gas prices, costs at the burner tip are actually falling -- down 3.5% nationwide in the last two months. Markets that have experienced substantial price increases have typically been markets affected by external events, such as the introduction of large volumes of higher cost imported gas from Canada as the new ANGTS pre-build system came on line. Prospective fears center on escalation clauses in natural gas contracts signed over the last five years, including the monthly Section 102 and Section 103 price adjustments authorized by the NGPA. However, many of those contracts do contain market out clauses which are now being exercised at an accelerating pace. Average gas costs are also being moderated by new purchases below NGPA ceiling levels, and by reductions in transportation costs by some pipelines.[15] And with producers today actively searching for markets, pipelines have the leverage necessary to secure relief from escalators in existing contracts that lack market outs.

Many Members of Congress have expressed concern about the consequences of take-or-pay requirements in gas purchase contracts. Let me call your attention to a study released last December by Energy Secretary Hodel, which showed that take-or-pay clauses have had no more than a 4% impact on residential gas prices.[16]

The shift in drilling activity from gas to oil. For many months this Committee has been beseiged with predictions that exploratory activity would shift away from natural gas and toward oil. Let me offer two facts. In 1981, despite the fact that oil completions outnumbered gas completions by a factor of more than 2 to 1, gross additions to reserves totalled only 87% of our nation's oil production. In contrast, gross additions to reserves exceeded 114% of our nation's 1981 natural gas production. Last year, in 1982, the number of oil wells completed rose 3.9 percent.[17] The number of gas wells completed rose 9.9 percent. We are still completing substantially more oil wells than gas wells. But comparing well completions without considering volumes of energy found is like comparing pass completions in football without considering the final score. What counts is not how many wells were drilled but how much energy was found. In 1981, with fewer than half as many wells, we found 37 percent more Btu's of gas than oil.[18]

Natural Gas Reserve Additions. The third great myth is that natural gas reserves are falling. I urge you to examine the following chart. It is based on data generated by AGA-API and the Department of Energy.[19] It shows natural gas reserves plummeting in the early- and mid-seventies. Additions to reserves rose in a perfect stairstep following passage of the NGPA. Then, 1981, our nation's proven gas reserves grew by 2.7 trillion cubic feet and in 1982, based on a 9.9 percent increase in drilling activity, we estimate proven reserves will grow by another 3 to 5 trillion cubic feet.[20]

U.S. Gross Natural Gas Reserve Additions/Production



Fuel Switching from Gas to Oil. The fourth great myth is that the natural gas industry is losing a major share of our markets to oil. Over the last several months it has been charged that industrial users are shifting en masse away from natural gas and toward residual fuel oil. Consider the facts: in 1982 the Department of Energy reported that consumption of residual oil fell 23%.[21] In contrast, industrial use of gas declined only 14%.[22] There have been isolated cases of fuel switching from gas to oil. A prominent example is by Southern California Edison. That utility's decision was prompted not by the NGPA pricing policy, but instead by the policy of the California Public Utilities Commission (PUC) to shift costs away from residential and toward industrial users. Recently, the California PUC eased the price burden on industrial consumers and as a result Southern California Edison has now shifted back to natural gas.[23] Poor rate design, not federal wellhead pricing policies, have been responsible for actual fuel switching problems that have occurred. And, by far, the overwhelming share of the reduction in industrial use of gas which has been documented is caused by the recession and by price-induced conservation.

Mr. Chairman, residual fuel oil is a by-product of the refining process. It is sold at a loss. Production of residual oil will therefore inevitably be limited. The natural gas industry should be unwilling to tolerate conversions of our industrial customers to oil. But the potential for large scale losses is much more limited than the Congress has been led to expect.

Price and Supply Consequences of Old Gas Decontrol. Advocates of legislation to raise old gas prices will today tell you that supplies will be greater and consumer costs lower if new gas prices are driven down as old gas prices are driven up. The opposite is true.

If you, Mr. Chairman, were in the business of drilling gas wells, or of raising capital to invest in natural gas drilling, which price would permit you to conduct a larger exploration program: a market in which the price for whatever gas you find is in the range of \$2.00 to \$2.30 or a market in which the price for whatever gas you find is in the range of \$3.00 to \$3.50? Which in turn will give the consumer the least cost supplies over time: a policy which encourages new drilling and discovery of added supplies, or a policy which discourages new drilling while promoting more rapid depletion of already known reserves? A one-third reduction in the wellhead price of natural gas would result in a disproportionate reduction in new reserve additions. This is so in part because of "reverse leverage" as debt service remains unchanged and in part because of a reduction in development of higher cost per unit reserves.

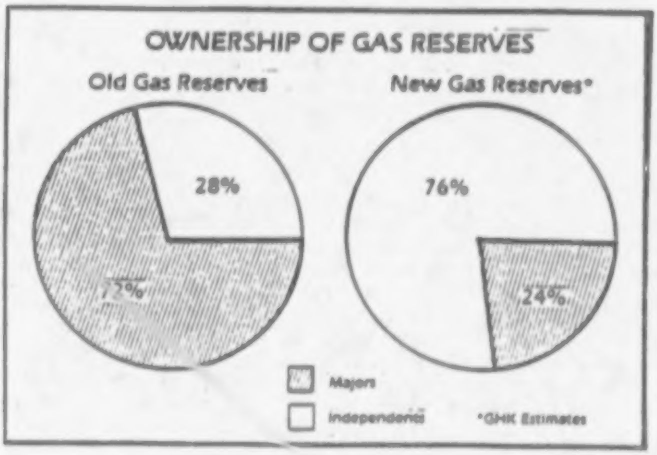
New discoveries would fall to disaster levels setting the stage for a price explosion in 1986 and beyond.

Revenue Transfers

Mr. Chairman, you will hear radically different views about the state of natural gas markets for an obvious reason: you are listening to companies with diametrically opposed economic interests at stake. Those interests are defined in terms of relative ownership of new and old gas reserves and also in terms of relative investment and annual earnings which flow from natural gas compared with oil.

Estimates provided by the Consumer Federation of America and C. Michael Butler, Chairman of the Federal Energy Regulatory Commission reveal that the top 20 energy companies own between 70 and 80% of the nation's old gas supplies. DOE data demonstrate that these major companies own only about 55% of the nation's total gas supplies. This means that independent companies must control between 75 and 80% of the nation's new gas supplies.

The following chart illustrates the share of new and old gas reserves owned by independents versus major companies:[24]



Of approximately 200 tcf in proven gas reserves, an estimated 65 tcf have been discovered since NGPA, leaving 135 tcf in old gas supplies.[25] After taking into account the relative share of reserves owned by majors versus independents, we find that each $1.00 increase in the price of old gas increases the value of major company assets from $95 to $108 billion, while reducing the value of independent owned assets by a comparable amount. Viewed another way, each $1.00 increase in the price of old gas transfers an estimated $8 billion in annual revenues from independent producers to major companies.

Unanswered Questions

Mr. Chairman, you have frequently been told by spokesmen for the organizations represented with me today on this panel to discount the views of the IGPC as a self-interested organization seeking to preserve $11 gas prices. There are no $11 gas prices today -- just as we predicted when we appeared before you 15 months ago. To each producer witness here on this panel and to each producer lobbyist who approaches you during the course of your deliberations, the following questions should be asked:

-- What share of your company's fixed investment is in natural gas and what share is in oil?

-- What share of your company's revenues come from gas and what share from oil, not just production, but also refining, transportation and marketing?

-- How much new gas do you own and how much old gas do you own?

-- What share of your drilling budget goes to gas and what share goes to oil?

Speaking for my own company, I can tell you that 99 percent of our investment is in natural gas and 95 percent of our revenues come from gas. We own 97 percent new gas, and only 3 percent old gas -- a reflection of a rapid expansion of drilling activity since NGPA. Let me add that 50 percent of our reserves are supplies found below 15,000 feet. Half of our reserves are classified as shallow new gas reserves. Our entire drilling budget goes to gas. We do not drill for oil.

I challenge each of my fellow producers on this panel to reveal the same information for their companies. If they did, this Committee would conclude that the panel before you today is not a gas producer's panel -- it is an oil producer's panel recommending policies to govern price and supply of the commodity that is the number one threat to petroleum's long term market share: natural gas. The greater the supply and lower the price of natural gas, the less these companies can expect to earn from the primary product they sell -- oil.

This Committee should also insist on answers to a critical set of questions that have not yet been addressed by the Administration. For example, if Secretary Hodel's bill is passed:

-- What does the Administration project the new gas price will be?

-- How many wells will be drilled with a new gas price at that level?

-- Where will the capital come from to drill, apart from the massive new revenues that will flow to the major oil companies? Since the major oil companies have declined to invest aggressively in new gas exploration at current prices, our country should not be forced to rely on their willingness to do so with much lower prices for newly found supplies.

-- What will be the relative share of future drilling activity for majors versus independents? (Petroleum Industry Research, Inc. last year estimated that 89% of all exploratory wells were drilled by independents.)[28]

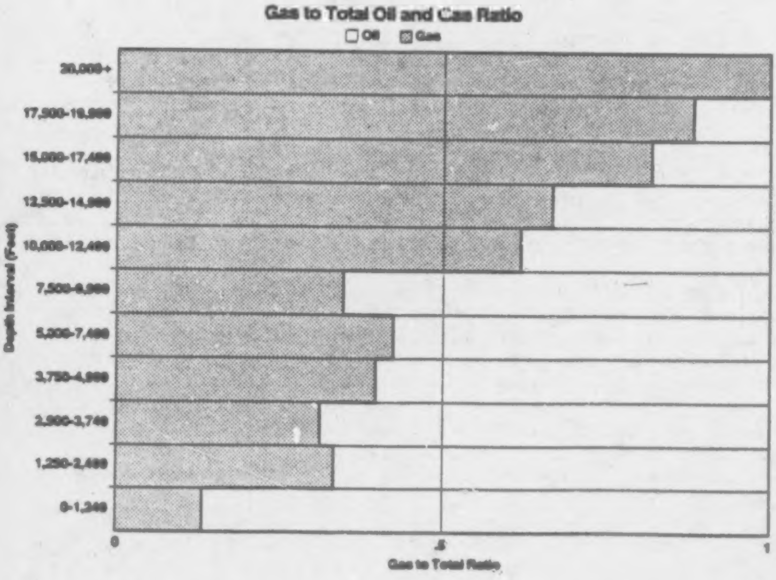
-- What level of new reserve additions will be generated each year by new gas prices in the range projected under the Administration's bill?

-- What will be the impact of lower levels of drilling and new reserve additions on consumer prices in the post-1986 period?

-- What has been the rate of increase/decrease for wellhead prices over the period 1978-1982? What trends are apparent in domestic wellhead price movements over the last 15 months?

Conclusion

Mr. Chairman, you have not received answers to these questions because the answers would reveal that the Administration's bill is not needed, and worse still that it would destroy one of the most productive industries in our country if it were passed. This bill would effectively shut off new drilling, except for marginal reserves in the least productive, but easiest to reach, sediments. Very few companies could afford to explore below 10,000 feet where the largest reserves of gas are being found. The following chart illustrates my point.[27] It shows that almost all oil is found above 10,000 feet, while almost all gas is found below 10,000 feet.



By transferring $100 billion in asset value and $8 billion in annual revenues to the majors, the Administration's proposal would effectively kill the independent gas producing industry. It would throw our country right back on the mercy of OPEC by the shutting of the development of our cleanest, most efficient, readily usable, and domestically abundant fuel -- natural gas.

My plea to this Committee is this: do not consider the issue of what to do about natural gas prices in a vacuum! Consider instead the outlook for our national economy and the enormous difference abundant supplies and moderate prices for natural gas can make.

For the first time in more than a decade a powerful deflationary force is moving through our economy in the form of lower energy prices for both oil and natural gas. Unlike the 1970's when commodity prices, led by energy, were rising and when any attempt to expand the monetary base led to higher inflation and higher interest rates, the Federal Reserve Board can now target interest rates in the range of five to six percent by this time next year and make ample credit available to meet the demands of both the private and public sectors without triggering a new inflationary spiral.

These lower interest rates, made possible by falling commodity prices, will generate a much stronger recovery than most forecasters predict, in turn lowering the deficit and easing the pressures that would otherwise cause credit costs to rise.

It is stronger economic growth, Mr. Chairman, not a complicated and totally counterproductive attempt to recontrol future gas supplies, while decontroling supplies found in the past, that will solve the problems that do exist in today's natural gas markets. Stronger growth means more markets for gas producers. More users mean lower fixed costs to consumers and the elimination of liabilities under take-or-pay clauses of natural gas contracts. More demand will also prompt more drilling, which means greater supplies and lower prices when new gas supplies are deregulated in 1985.

Mr. Chairman, my company, as you know, produces some of the most difficult to find natural gas in the nation. Our industry can compete successfully with $20 to $25 dollar per barrel oil because the events of the last year have not only resulted in dramatically lower prices; they have also resulted in dramatically lower costs. To develop this resource, we need only free access to markets -- repeal of incremental pricing and the Fuel Use Act -- a stable regulatory environment without the threat that new exploration will be recontrolled and a strong economy to stimulate demand. We -- the entire independent natural gas producing industry cannot do the job our nation has come to depend upon us to do -- discovering and delivering to consumers the abundant reserves that are now known to exist -- if Congress insists on passing legislation which once again ties us in regulatory knots and gives us in real terms price incentives beneath those that led to the widespread curtailments and shortgages that occurred just six years ago. The choice is this: moderate priced, abundant supplies of energy made available by a highly competitive, independent natural gas industry, or increasingly costly, and scarce reserves of gas controlled by companies whose financial interest lies in promoting greater use of oil, putting our country right back in the grip of shortages and at the mercy of OPEC for something every American citizen and industry needs. Our national independence depends on preserving a strong independent gas producing sector. If you give us the chance, I guarantee you we will give this country abundant energy below the equivalent cost of oil for the rest of this century and much of the next. I do not make an idle promise of what we can do in the distant future; I simply state what we are doing right now and what we will continue to do if you give us the chance.

Thank you.

FOOTNOTES

1. See Appendix A.

2. Hearings on Implementation of Title I of the Natural Gas Policy Act of 1978 Before the Committee on Energy and Natural Resources of the United States Senate, 97th Cong., 1st Sess. (Domestic Petroleum Council Analysis of Title I of the Natural Gas Policy Act of 1978).

3. Ibid. (Testimony of John M. Connor on Behalf of the Natural Gas Supply Association).

4. Ibid. (Statement of H.E. [Gene] Wright, Chairman, Natural Gas Committee, Independent Petroleum Association of America).

5. Ibid. (Statement of Robert A. Hefner, III).

6. Ibid.

7. Ibid.

8. U.S. Department of Energy, Energy Information Administration, Monthly Energy Review, January 1983, p. 89 (DOE/EIA (83/01)).

9. A price of $1.80 per mcf in 1978 dollars, commonly received by producers in the pre-NGPA Oklahoma intrastate market, would equal a price of $2.60 per mcf in 1983 dollars. The pre-NGPA Texas intrastate average wellhead price of $2.25 per mcf would equal a wellhead price of $3.25 in 1983 dollars.

10. Potential Gas Committee, Potential Supply of Natural Gas in the United States (as of December 31, 1980) p. 35 (Potential Gas Agency, Colorado School of Mines, May 1981).

11. See Appendix B for copies of articles.

12. See Appendix B for copies of articles.

13. Congressional Record -- Senate, 97th Cong., 2nd Sess., p. S.14708. (Statement of Senator McClure).

14. Ibid.

15. Energy Daily, "Natural Gas Prices in Texas Start to Slide," February 22, 1983. p. 1, 4.

16. Inside Energy, "How DOE Views 'Alleged' Take-or-Pay Problems in Natural Gas Markets," December 17, 1982. p. 5.

17. Petroleum Information Corporation, Topics, "Perspective '83: Looking Back . . . And Ahead," Volume 3, Number 1, Winter, 1983. p. 2.

18. U.S. Department of Energy. For data on well completions see Monthly Energy Review, Op. Cit. p. 56. For reserves data see Principal Findings of the U.S. Crude Oil, Natural Gas and Natural Gas Liquids Reserves 1981 Annual Report.

19. Reserves data from Principal Findings of the U.S. Crude Oil Natural Gas and Natural Gas Reserves 1980 and 1981 Annual Reports, for 1980 and 1981 and from Reserves of Crude Oil, Natural Gas and Natural Gas Liquids in the United States and Canada: 1975-1979. (API, A.G.A.).

20. Assuming productivity of drilling no more than held constant between 1981 and 1982 and also assuming consumption of 18.4 tcf, a 9.9 percent increase in drilling would generate a net increase in proven reserves of 5 tcf, or 127 percent of replacement.

21. Energy Daily, Op. Cit.

22. Ibid.

23. Energy Daily, "California Gas Loan Restored," March 1, 1983.

24. Data on old gas reserve ownership from Hearings on the Current State of Natural Gas Markets Before the Subcommittee on Fossil and Synthetic Fuels of the House Committee on Eneregy and Commerce, 97th Cong., 2nd Sess. (Statement of Ann K. Lower, Director of Information, Consumer Federation of America). Estimates of new gas reserve ownership prepared by the GHK companies based upon data presented at Appendix C.

25. Reserves data from Principal Findings of the U.S. Crude Oil Natural Gas and Natural Gas Reserves 1980 and 1981 Annual Reports, for 1980 and 1981 and from Reserves of Crude Oil, Natural Gas and Natural Gas Liquids in the United States and Canada: 1975-1979. (API, A.G.A.).

26. Meyers, Energy Daily, May 11, 1982, p. 2.

27. Data derived from Joint Association Survey. (API, 1981).

APPENDIX A 3/11/83

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Dyco Petroleum
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Petroleum Investments, Ltd.
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APPENDIX B

NATURAL GAS INTELLIGENCE FEBRUARY 28, 1983

UNITED FREEZES PRICES: INTRASTATES FOLLOW SUIT

In the most far reaching price reduction policy yet established by an interstate pipeline company, United Gas Pipe Line Co., has set price ceilings on approximately 20 percent of the natural gas it purchases each day.

Citing falling crude oil prices, competition from alternative fuels and declining overall demand, United Gas said the action is being taken to prevent further loss of markets and to reduce gas costs.

The company is a subsidiary of United Energy Resources Inc., of Houston. Effective March 1, United Gas will pay a maximum of $3.34 per MMbtu net of state severance tax for all price controlled natural gas including tight sands, and about $4.21 per MMbtu net for deep gas. The $3.34 freeze figure is the maximum Section 102 price for March. This is the second price reduction made by United Gas in the past six months.

In August, 1982, the Company set a maximum net price of $5.35 per MMbtu for all Section 107 gas. This latest move effects purchases of 480 MMcf/d, about one/fifth of United's total daily volume of 2.5 Bcf and reserves of 500 Bcf or about 12 percent of the total 4 Tcf reserve.

These transactions, however, represent about half of its total number of contracts. United did not say how many producers were involved. They include producers in Texas, Oklahoma, Louisiana, Alabama, New Mexico and Utah and number substantially more than the 104 involved in the previous price cut.

One of the producers is Cotton Petroleum Corp., one of the subsidiaries of United Energy. The company said that almost all of United's contract volumes of 25 MMcf/d from Cotton are covered by the price reduction.

--In another price move several Texas producers reported that Houston Pipeline Co., the state's largest intrastate carrier, has notified them that it also will impose a price ceiling of $3.34 per Mcf on all gas purchases including deep and tight sands, effective March 1. Houston Pipeline declined to comment last week but James B. Walzel, its president, said recently that the market is becoming softer and that the section 102 price might not hold much longer. Producers also said they expected other Texas intrastates to very quickly follow with their own freezes, since HPL's average cost of gas is already lower than their competitors.

THE ENERGY DAILY FEBRUARY 28, 1983

UNITED CUTS GAS PURCHASE PRICE A SECOND TIME

United Gas Pipe Line Co., which declared a market-out on its high-cost gas last summer, went one better last Friday and declared a second market-out to push its gas costs still lower. Henceforth, the Houston-based interstate pipeline will pay no more than $4.50 per million Btu for deep gas nor more than $3.34 for any other sort of gas. The latter figure is the March federal price ceiling for Section 102 gas (from new wells).

Last August, United Gas became the third pipeline (after Transco and Michigan Wisconsin) to react to sagging gas markets by taking advantage of market-out clauses in its contracts; it set $5.72 per MMBtu (August's price ceiling for gas from tight formations) as its limit for purchases of high-cost (Section 107) gas. Section 107 gas contributed about 180 million cubic feet daily (slightly more deep gas than tight sands gas), then representing some 8 percent of United's supply. Producers, given the option to sell their gas elsewhere, chose not to; United lost not an iota of the estimated 260 billion cubic feet of Section 107 gas reserves it had under contract.

For United, with its heavy load of industrial customers, gas markets have worsened since last summer; now, the pipeline is buying just 30 percent of the gas it has under contract, compared to about 50 percent a year ago. (United, unlike other pipelines, cuts all of its producers back proportionately; it figures it comes out ahead by incurring take-or-pay obligations rather than eschewing the older, cheaper gas that other pipelines have been shutting in.) With declining demand and falling residual fuel prices, United thought another round of price cuts in order. It declared market-outs on every contract it could—on 1,250 of them, about 40 percent of its supply contracts. They cover about 500 Bcf of reserves and 480 MMcf/day of contractual volumes—roughly 7 percent of total contractual volumes and 25 percent of the pipeline's current takes. With this move, United expects to shave $90 million from its annual gas costs. Section 107 gas prices will be affected immediately; Section 102 gas will feel the impact gradually, as its federal ceiling price rises each month but United's own ceiling doesn't.

Earlier last week, United got rid of an expensive problem dating from a far different gas marketing era—the '70s. The pipeline reached an agreement with its largest customer, Gulf States Utilities Co. of Beaumont, Texas, which has been seeking $700 million in damages arising from United's curtailments of gas throughout the 1970s. United Gas agreed to pay Gulf States $112 million in cash and extend for five years (until 1992) an existing supply contract that calls for delivery of 400 MMcf/day. Besides that, United's intrastate pipeline affiliate—United Texas Transmission Co.—will sell at least 27.4 Bcf annually to the utility from 1985 to 1995 at prices "comparable" to what the line charges its other major industrial customers. Both United lines agreed to transport additional volumes of gas to Gulf States at their standard fee. For its part, Gulf States will drop its lawsuit (once the settlement becomes final) and waive any rights to damages from curtailments that may occur until its contract with United Gas expires.

This pact has been approved by Louisiana regulators, and a motion to dismiss Gulf States' lawsuit must be presented in state court. United still faces five other lawsuits arising from the curtailments of the '70s. The plaintiffs in these cases seek a total of $1.4 billion (plus interest) from United. But the pipeline has no settlement discussions underway with these customers, and intends to "continue the vigorous assertion of its defenses against [them]," said J. Hugh Roff, chairman of United Energy Resources, Inc., the pipeline's parent company.

—Burt Solomon

THE ENERGY DAILY FEBRUARY 22, 1983

Natural Gas Prices In Texas Start To Slide

Prices are falling in Texas' intrastate natural gas market. Last week, the Texas Railroad Commission approved price cuts in two gas supply contracts, including one between Lone Star Gas Co.—one of Texas' biggest pipelines—and its largest customer, Texas Utilities. Another reduction in gas costs was approved by the commission the week before.

Lone Star has been selling gas to Texas Utilities since 1959, usually about 50 billion cubic feet annually. Troubled by marketplace competition, the Dallas-based pipeline agreed late last month to amend the contract, slicing from 58 cents to 39 cents per thousand cubic feet the amount it appends to its own gas-buying costs to calculate its price to Texas Utilities. This was accompanied by another price-curbing alteration. Starting January 1, the way Lone Star calculates its gas costs was to have changed; instead of basing its gas charge to Texas Utilities on the weighted average cost of all of its gas, it was to have begun using only contracts signed after 1978. Under the renegotiated contract, that switch was scotched; it would have meant a "substantial" jump in what Lone Star charges Texas Utilities and would have "resulted in an unrealistically high price," Alan Tarrant, director of Lone Star's industrial sales, said late last week. "It is not beneficial to any of us to force a customer away from using gas. We think that would have been the long-term effect." In the renegotiation, the pipeline wrested one change in its favor: quashing a significant reduction in Texas Utilities' required purchase levels that was to have gone into effect this year. Instead, Texas Utilities is obligated to buy roughly the same volume this year as last—close to 50 Bcf.

Lone Star, which saw its gas sales to industry and utilities slide by 11 percent last year, faced competition from other pipelines for Texas Utilities' business, Tarrant acknowledged: "There's a substantial competition within Texas among intrastate suppliers and there seems to be a tendency by interstate pipelines to enter into the intrastate market." (Lone Star's total sales reached about 500 Bcf last year; the price it paid for Texas production averaged $3.86 last December, versus $3.21 in December 1981.) For Texas Utilities, the Lone Star contract represents almost 10 percent of its total fuel. The company's utilities burn lignite for 55 percent of their generation and gas for virtually all the rest. The alteration in its contract with Lone Star (effective March 3) won't reduce utility bills but rather will offset part of anticipated increases, according to a Texas Utilities spokesman.

The second contract amendment approved by the railroad commission last week involved South Cen-Tex Gas Co.—an intrastate line based near Houston—and Liquid Energy Corp., a gas processor in Fayette County (between Austin and the Gulf Coast). South Cen-Tex cut its gas price from $4.15 to $3.66 per million Btu, retroactive to January 25. That will reduce the pipeline's annual revenues by an estimated $248,000.

Earlier this month, the commission accepted a cut in transportation rates by Adobe Gas Co., a Midland-based intrastate line. Effective last week, Adobe is charging 36 cents rather than 47 cents to move each million Btu of Patoil Corp.'s gas to Intratex Gas Co. According to a railroad commission examiner, Adobe anticipates transporting increased volumes of Patoil's gas so it won't see its revenues fall; indeed, revenues eventually are expected to rise. Adobe and Patoil agreed to these new terms last July but didn't submit them for railroad commission approval until last month. The commission must approve all such contract alterations as long as the pipeline's rates are substantially the same, neither party was at a bargaining disadvantage, and competition existed from other pipeline suppliers.

NATURAL GAS INTELLIGENCE FEBRUARY 21, 1983

INTRASTATES OFFERING LOWER PRICES IN TEXAS MARKET

With the interstates straining under an oversupply, the intrastates are moving into the spotlight in the Texas natural gas market, and the prices are going lower.

Houston Pipe Line Co. recently signed a deep Texas well at a price of about $3.15 per Mcf,(approximately 80 percent of low sulfur No. 6), industry sources say. And a Pioneer Corp., intrastate subsidiary in Texas says it has been buying Section 102 gas at a price of 80 percent of high sulfur No. 6 oil ($2.87 on the Gulf Coast in January) for about three months now. Pioneer has had their offers rejected on only a couple occasions by producers who said they had been offered the maximum lawful price ($3.32/MMBtu) by others.

Houston Pipe Line, meanwhile, will begin taking 3 MMcf/d from the No. 1 Wirt Davis Trust in Polk County, Texas, about March 1. The well is operated by Patrick Petroleum. It was the first Tuscaloosa formation producer completed in Texas testing 6.538 MMcf/d of gas and 82 b/d of condensate on a 12/64 inch choke with 11,340 pounds flowing tubing pressure from perforations 16,552 to 16,562 feet. Calculated absolute open flow a rate was 36 MMcf/d and under Texas Railroad Commission allowable regulations the well could have an allowable rate of 9 MMcf/d.

Neither company will state the price paid, but other sources indicate that the gas is going for approximately $3.15 per Mcf, possibly the lowest price being paid in the nation for Section 107 deep gas. Houston Pipe Line would say only that the price is based on a percentage of No. 6 oil low sulfur fuel oil. The contract calls for takes of 80 percent of the allowable, or market demand whichever is less.

Texas sources also said that other deep pay zones as well as shallower producing intervals in the Frio and Wilcox formations are present in the well. Houston Pipe Line's decision to wait for market factors to bring down the price of gas before going after big reserve packages appears to be paying off.

At the close of its last fiscal year in July, 1982, the company claimed reserves of 2.6 Tcf, but industry sources are estimating that figure has climbed by approximately 3 percent in the past 6 months.

NATURAL GAS INTELLIGENCE JANUARY 24, 1983

CHANNEL INDUSTRIES CUTS ALL PRICES TO $3

Channel Industries Gas Co., an intrastate subsidiary of Tenneco Oil Co., has cut the price it will pay on all contracts across the board to $3.00 per Mcf, suppliers said last week. The pipeline, which serves mostly industrial customers along the Gulf Coast, reportedly notified its suppliers in a letter dated Jan. 1, 1983 that it was invoking force majuere due to economic conditions. Channel officials would not confirm the report. In recent weeks other pipelines serving Gulf Coast industrials have estimated the competitive price in that market at between $3.00 and $3.50 per Mcf.

THE ENERGY DAILY JANUARY 21, 1983

Another Pipeline Joins Price Slicing

Northwest Central Pipeline Corp., battered and bruised by consumer anger over spiralling gas prices in its Kansas and Missouri markets, declared a "market-out" this week. Henceforth, the pipeline (known as Cities Service Gas Co. until it was sold off in November to Northwest Energy Co. amidst Occidental Petroleum's takeover of its parent company) will pay no more than what the government allows for new gas—currently, $3.30 per million Btu—for production from tight formations and from deep, deregulated wells.

Company officials think this is the first time a pipeline has triggered a market-out clause for tight sands gas. Fourteen of the 15 contracts (with 10 producers) covered by this market-out are for tight sands gas, which Northwest Central has been buying for $6.20 (the $5.44 federal incentive price plus reimbursable taxes). The fifteenth is Northwest Central's sole contract for deregulated gas, produced by Koch Industries and sold for $7.50. The gas volumes covered by the 15 contracts are modest, however—amounting to 2.6 billion cubic feet of 1982 gas, just 0.9 percent of the pipeline's total purchases. (Koch's deep gas came to 123 million cubic feet of that.) Northwest Central buys much greater volumes of tight sands gas under contracts with Amoco that are too old (dating from the early and mid-'70s) to contain market-out clauses.

Northwest Central president E.S. Hanson maintained that the gas prices his company charges (averaging $3.34 per thousand cubic feet) are among the cheapest in the nation. "The price rollback which we have initiated is but one in a series of actions which we will take to obtain price relief for our customers," he intoned. Earlier this month, Northwest Central asked the Federal Energy Regulatory Commission to relieve it of its obligation to move at least 60 billion cubic feet this year through the company's 611-mile line from Rawlins, Wyoming—the locale of Amoco's tight sands gas—to Hesston, Kansas. Only 30 Bcf went that route last year, and Northwest Central contends that requiring throughput to reach 60 Bcf in 1983—as the old Federal Power Commission mandated when it certified the line a few years ago—would cost the company's customers an extra $578 million over the next five years.

NATURAL GAS INTELLIGENCE JANUARY 24, 1983

EL PASO MARKETS OUT AT $5 PER MMBtu

El Paso Natural Gas Co., and Northwest Central Pipeline joined the tide of market-outs last week, as Texas Eastern and Transwestern pipelines revealed the terms of their action earlier this month.

El Paso's market out affected the largest amount of gas, dropping the price on 250 MMcf/d of deep and tight sands production to $5 per MMBtu plus applicable taxes. The action, effective March 1, 1983 includes some 40 MMcf/d from its producer affiliate, El Paso Production Co.

It will affect about 75 percent of the company's total 107 purchased gas volume and reduce total projected gas costs, royalties and taxes by as much as $250 million annually. The reduction in purchase price also cuts the semi-annual purchased gas adjustment by approximately 20¢ per Mcf, effective April 1.

Northwest Central Pipeline (formerly Cities Service) has marketed out on 2.6 Bcf annually in tight sands production to the Section 102 price of $3.30 per MMBtu. Letters went out Jan. 10, 1983 to 10 producers holding 15 contracts.

The transmission subsidiaries of Texas Eastern Corp., said their $5 market-out on deep and tight sands gas will affect producers in Texas, New Mexico, Louisiana and the offshore. Before rolling back prices to $5.00 per MMBtu the two pipelines had been paying between $5.50 and $9 per Mcf for Section 107 production.

On the Texas Eastern Transmission system 12 deep gas contracts and 17 tight sands contracts with 25 producers covered purchases of 92 MMcf/d of deep gas or 3.6 percent of Texas Eastern's total volume and 5 MMcf/d of tight sands gas.

Prior to exercising the market out clauses Texas Eastern had filed a purchase gas adjustment calling for a 22¢ reduction in its delivered price of gas to its customers. The market out will reduce the delivered price another 15¢ per Mcf.

The price reduction, for example, will cut Texas Eastern's delivered cost of gas in New Jersey to about $3.50 per Mcf with a 100% load factor.

On the Transwestern system, 58 deep gas contracts and 65 tight sands contracts with 64 producers were affected. Purchase volumes included 30 MMcf/d of deep gas, 3.6 percent of the total and 64 MMcf/d of tight sands gas for 7.6 percent of the total volume. Exercising the market out clauses will enable Transwestern to reduce its delivered price to Southern California by 12¢ to 14¢ per Mcf. Previously the price has been $4.19 per Mcf.

NATURAL GAS INTELLIGENCE JANUARY 17, 1983

TEXAS EASTERN, TRANSWESTERN MARKET OUT

Texas Eastern Transmission, and affiliated Transwestern Pipeline Co., have exercised market-outs on all their deep and tight sands contracts which had market-out provisions to a $5 per MMBtu all inclusive rate.

Letters went out from the pipelines, both subsidiaries of Texas Eastern Corp., to producers setting the market-out date as Jan. 1, 1983. A source said much of the gas involved was from new wells which had yet to go on production.

A company spokesman said the action would result in a 10¢ to 17¢ per Mcf decrease in the average cost of gas on both systems. The pipelines' costs had reached market clearing levels due to the soft market, he added.

Texas Eastern recently signed a 15-year agreement with producers in the East Seven Sisters field located in Duval County in south Texas calling for 50 percent takes at $5 per Mcf with market-out provisions. Arco Oil & Gas Co., is the operator of the field and Texas International Co., of Oklahoma City has a 20 percent interest.

Currently two wells with a combined production capacity of 30 MMcf/d from the deep Wilcox formation below 17,000 feet have been completed and a third has been spudded. The field has prime potential and as many as 10 wells may be drilled to develop it. There are other potentially productive sands between 10,000 and 16,000 feet. Future production also is covered by the contract.

Discussing the terms of the agreement a Texas International spokesman said, "We have come to a new world as far as take or pay provisions are concerned. And we believe it will be like this at least until 1985."

That date is significant not because of any connection with the Natural Gas Policy Act, but because it is the earliest that Texas International expects substantial increases in natural gas demand. "We are down-sizing our thinking," the spokesman continued. "We can't have $60 a barrel and $9 an Mcf expectations any longer. We made money 30 years ago on $2 oil and 10¢ gas and we have to learn to make money on $20 oil and $3 gas."

Two of the state's largest intrastate transmission companies have exercised market-out clauses in almost all of their deep natural gas contracts, and one has extended the policy to tight sands gas as well. Neither Valero Transmission Co., a subsidiary of San Antonio based Valero Energy Corp., nor Intratex Gas Co., the west Texas-based subsidiary of Houston Natural Gas Corp., were taking large volumes of section 107 gas. But even small amounts were causing their sales prices to go above the market clearing level.

Valero was buying 16 MMcf/d of Section 107 production from west and south Texas. It cut the price on deep gas to the Mexican import price of $4.94 per Mcf and rolled back the tight sands prices to the Section 102 level. A Valero spokesman said that the company had been paying up to $8.32 per Mcf on deep gas.

The move covered 44 different contracts and 38 producers. Two producers have rejected the price but are still selling to Valero. One producer has terminated his contract, but the spokesman did not know whether he had found a new purchaser.

Several years ago Intratex had signed contracts covering 20 MMcf/d that was tied to the Mexican gas price, then $4.46 per Mcf. James D. Walzel, president of HNG's transmission company, said the agreements had both price redetermination and market-out provisions. The prices had gone above the $8.00 per Mcf level before being rolled back to the current tight sands rate.

Walzel said that in the current market he cannot predict how long the tight sands price will hold up. Already transmission companies are battling each other, as well as alternate fuel suppliers, merely to maintain existing customers. Adding new customers apparently will require the pipelines to cut their gas acquisitions costs even further. According to Walzel any natural gas purchased for more than $3.50 per Mcf exceeds the current market clearing price.

Valero and Houston Pipe Line Co., another HNG subsidiary, both have submitted contract proposals to the San Antonio City Public Service Board to supply the city's municipal utility system. Walzel pointed out that the competition was forcing both companies to examine their gas purchase policies very carefully in an effort to keep sales prices as low as possible. The final contract or contracts will not be awarded until at least mid-February, but Walzel said "no matter how it comes out the consumers of San Antonio will be the real winners."

NATURAL GAS INTELLIGENCE OCTOBER 11, 1982

MID LOUISIANA TO DROP DEEP GAS TO $3.45 PER MMBtu

Mid Louisiana Gas Co., has announced its intention to offer stripper well rates, currently $3.45 per MMBtu to producers of Section 107 deep natural gas effective Jan. 1, 1983.

Vernon Woods, president of the Celeron Corp., subsidiary told a recent hearing before the Louisiana office of Conservation that Mid Louisiana will lower the price it pays for deep gas because the company is losing industrial sales to No. 6 fuel oil. About 18 percent of the company's gas supply could be affected by the decision, Woods said.

Mid Louisiana, a "low cushion" interstate pipeline had previously purchased deep gas from the Tuscaloosa Trend, Irene and Port Hudson fields at an "indefinite pricing arrangement". The price gradually eclipsed $9 and on Aug. 1, the company returned to producers with an offer of $5.35 per MMBtu, the going rate for tight sands gas.

The producers accepted the initial offer but the $5.35 price has since proven to be too high for Mid Louisiana. Woods noted at the hearing that his company had recently lost off-system sale of 6 MMcf/d to Liquid Carbonic Corp., of Geismar, La., to an intrastate competitor. Fully one-third of Mid Louisiana's gas supply is produced from old stripper wells in the Monroe, La., gas fields.

Sales of natural gas by Mid Louisiana approached 33 Bcf in the year ending April 1, 1982, about a half of it—going to industrial customers. Woods said the company was trying to get into a position to serve more city gate customers.

APPENDIX C

MARKET CONCENTRATION IN THE GAS PRODUCTION INDUSTRY

(Tcf)

	1975		1979		1980		1981	
	Reserves	Production	Reserves	Production	Reserves	Production	Reserves	Production
Top 20 Companies	146.0	11.7	115.6	10.1	111.9	9.5	110.9	9.1
Total Industry	228.2	19.2	201.0	19.7	199.0	19.6	202.1^{P}	19.6
Percentage Owned by Top 20	64.0%	60.9%	57.5%	51.1%	56.2%	48.2%	54.9%^{P}	46.6%

Note: P = Projection

Sources: Reserves data from Principal Findings of the U.S. Crude Oil, Natural Gas and Natural Gas Liquids Reserves 1980 Annual Report (EIA, October, 1981) for 1979-1980 and from Reserves of Crude Oil, Natural Gas and Natural Gas Liquids in the United States and Canada: 1975 (API, A.G.A. and COA, 1976).

Gas production from Monthly Energy Review: March, 1982 (EIA, 1982).

NATURAL GAS RESERVES DATA BY COMPANY

(Bcf)

	Reserves 1/1/80	Reserve Additions	Production	Reserves 1/1/81	Reserve Additions	Production	Reserves 1/1/82
Exxon	17,200	774	(1,329)	16,687	1,452	(1,215)	16,924
Atlantic Richfield	13,354	662	(472)	13,546	280	(448)	13,378
Standard of Indiana	8,654	592	(812)	8,434	1,258	(835)	8,857
Texaco	9,593	(1,034)	(994)	7,555	236	(892)	6,899
Sohio	6,672	73	(44)	6,705	40	(47)	6,699
Shell	7,065	737	(651)	7,149	653	(664)	7,139
Mobil	6,498	168	(718)	6,205	766	(661)	6,310
El Paso	6,174	127	(286)	6,015	325	(286)	5,980
Union	6,038	185	(442)	5,781	125	(433)	5,436
Standard of California	5,300	535	(456)	5,344	400	(439)	5,294
Subtotal for Top 10 companies	86,474	2,810	(6,203)	83,347	5,498	(5,920)	82,916
Gulf	5,052	153	(662)	4,543	244	(615)	4,172
Sun	3,195	280	(384)	3,424	248	(381)	3,296
Phillips	3,656	38	(331)	3,363	378	(320)	3,425
Tenneco	3,319	305	(408)	3,259	373	(437)	3,387
Cities	3,197	39	(297)	2,939	111	(301)	2,749
Conoco	2,681	264	(285)	2,660	211	(269)	2,602
Getty	2,546	273	(313)	2,603	193	(319)	2,476
Marathon	2,177	116	(164)	2,129	62	(161)	2,031
Superior	1,891	317	(296)	1,912	261	(288)	1,886
Union Pac.	1,463	390	(112)	1,755	360	(118)	2,002
Subtotal for Top 10-20 Companies	29,177	2,175	(3,252)	28,587	2,441	(3,209)	28,026
TOTAL Top 20 Companies	115,651	4,985	(9,455)	111,934	7,939	(9,129)	110,942

Note: The ten largest gas reserve owners replaced 45% of their production with reserve additions in 1980 and 93% in 1981.

The twenty largest gas reserve owners replaced 53% of their production with reserve additions in 1980 and 87% in 1981.

Senator **Murkowski** [presiding]. Thank you very much, Mr. Dage. Our next witness will be Ms. Britann Wallace, chairman, Natural Gas Committee and Independent Petroleum Association of Mountain States.

Miss Wallace, we welcome you to the committee and ask you to proceed with your testimony.

STATEMENT OF BRITANN WALLACE, CHAIRMAN, NATURAL GAS COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES

Ms. **Wallace**. Thank you, sir. I appreciate the opportunity to testify today before this committee. My name is Britann Wallace, and I am chairman of the Natural Gas Committee, the Independent Petroleum Association of Mountain States [IPAMS].

IPAMS is a regional trade association of over 1,800 members representing independent oil and gas producers and related service companies in the 11 Rocky Mountain States.

IPAMS has submitted written testimony to the committee which I will try to highlight this morning, or afternoon now.

IPAMS would like to congratulate the administration for their work in the development of S. 615. This bill recognizes the complexities in all segments of the natural gas industry in the United States.

It goes a long way towards providing the industry with a way to correct the problems we face. At the same time, it provides the consumer relief so desperately needed in all parts of the country today.

IPAMS believes that S. 615 supports our organization's natural gas policy on the issues of total decontrol of wellhead pricing, repeal of end use restrictions on natural gas, the promotion of the long-term assurance of adequate supplies for our natural gas market so that we can maintain our market, regain the markets we have lost in recent years, and reduce our dependence on foreign energy supplies, also to provide consumer relief from artificially high gas pricing due to controlled markets.

In keeping with these policies, IPAMS would like this committee to consider some additional points in their actions on S. 615.

First, the gas market needs to become national in scope. The proposed bill encourages direct negotiation of contracts between producers and consumers, and this we feel would begin to solve problems which exist because of local access barriers in current gas markets.

To expand the market capabilities granted in the proposed bill, IPAMS would like to see intrastate pipelines included under the contract carriage provisions as a step towards developing a truly integrated national gas marketing system.

Second, under S. 615, an interstate pipeline must transport an amount of gas under a market-out contract up to the amount which equals the highest 12-month average during the past 36 months.

Consideration needs to be given to volumes of gas that would have been produced from wells on the line which haven't been operating during that 36-month period.

This volume needs to be included in the 12-month production average that determines available line capacity.

Third, IPAMS feels that the bill needs to deal with the continuation of existing minimum purchase obligations of the distribution companies to the pipeline.

Many distribution companies who would be potential markets for lower cost gas will be prevented from purchasing due to these obligations.

Fourth, a provision should be developed in the bill which will insure that pipeline affiliates compete equally with nonaffiliated producers during the time between enactment and January 1, 1986.

IPAMS is concerned that favorable treatment of affiliates would have significant impact on the gas cap price and reduce the price a pipeline could pay nonaffiliated producers after the cap is in place.

Fifth, IPAMS is concerned that old renegotiated gas contracts which are allowed to be included in the gas cap price will lead to continued distortions of gas pricing.

If renegotiated old gas is included in the cap formula while imports and 107 are left out, the cap will force the price of conventional 102 and 103 gas down below a market clearing level and discourage replacement of diminishing reserves.

This could lead to future shortages and price fly-ups.

Six, IPAMS believes that to create and maintain a market responsive price cap, the formula must include imported gas.

The import gas contracts are necessary to meet winter demand, particularly in the Rocky Mountain States. The higher the percentage of imported gas and a pipelines mix means the less flexibility that pipeline will have to extend a market clearing price to sellers under new contracts.

As with old gas, this lowered price will affect the price cap and exert downward pressure on controlled prices, again discouraging drilling needed to replace diminishing reserves.

In addition, exploration efforts that could take place in the United States may be directed outside of the Nation. Finally, IPAMS is concerned about the inclusion in the bill allowing the FERC to retain the right to lower the 107 tight sands incentive price.

The majority of tight sands gas is sold under contract containing market-out provisions. These market-outs are being invoked now in the Mountain States in response to market signals, resulting in lowered tight gas sands prices.

We believe that these market signals should be allowed to continue to show the degree of incentive which exists and to dictate tight sands pricing rather than imposing more unnecessary regulatory requirements.

I would like to close by saying that IPAMS supports the concepts included in S. 615, and we hope this committee will give consideration to the points we have raised.

[The prepared statement of Ms. Wallace follows:]

STATEMENT OF BRITANN WALLACE, CHAIRMAN, NATURAL GAS COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES

Good morning. I appreciate the opportunity to testify today before this Senate Energy & Natural Resources Committee. My name is Britann Wallace, I am the chairman of the Natural Gas Committee for the Independent Petroleum Association of Mountain States (IPAMS).

IPAMS is a regional trade association of over 1800 members representing independent oil and gas producers and service companies in the eleven Rocky Mountain states (North Dakota, South Dakota, Nebraska, Montana, Wyoming, Colorado, New Mexico, Idaho, Utah, Nevada and Arizona).

IPAMS recognizes that the 1980's will prove to be a critical decade for the energy policy of the United States. This policy must recognize the vital contribution to the nation that natural gas can fulfill. The natural gas industry must have the freedom in the marketplace accorded alternate energy sources to secure the direction and stability necessary to function effectively for the benefit of all citizens and succeeding generations.

We applaud the efforts made by the administration in the development of S.B. 615. This bill recognizes the intricacy of the natural gas system in this country and acknowledges the concerns of all parties involved. S.B. 615 provides us with a vehicle to correctly address the market distortions that are occurring today under the NGPA of 1978. We have reviewed the bill and believe it is sound in concept but that certain modifications must be made to provide the best solution for all parties involved today and tomorrow.

IPAMS acknowledges the increasing need to provide consumers with relief to the problems they are encountering. Rather than address this relief on a short-term basis, as has been suggested by numerous other legislative proposals, we feel the solution should reflect a short-term bridge that leads to a long-term balancing of adequate, dependable supplies at reasonable market prices. Consumers are currently facing market distortions in supply and pricing of gas because of the complex regulatory mechanisms mandated under the NGPA of 1978 and the energy scenario assumed at that time. The experience of NGPA since 1978 only continues to prove the erroneous assumption that artificial markets created by government regulations will best serve the consumer. Although we are considered producers, ourselves, employees, family and friends are also all consumers of natural gas. We are just as concerned as any other "consumer group" in this country on fair pricing.

Under deregulation, the production of the nation's existing natural gas reserves will be allowed to respond to demand in the energy marketplace. The expenditures of drilling dollars will be directed to seeking the greatest volume of energy reserves for each dollar spent rather than seeking lower volumes of reserves which can be priced artificially high.

In turn, the long term assurance of continued adequate supplies of natural gas at prices competitive with alternate fuels will encourage the most efficient and cost effective energy mix for users in all segments of the national economy. This more efficient allocation of our energy resources can serve only to reduce the nation's reliance on foreign sources of energy and to promote a strong, stable economy.

As an important component of the price escalation consumers are experiencing today, the continued loss of markets for natural gas will only serve to further increase prices to consumers and eventually hasten a new shortage. Because the NGPA has facilitated artificially higher gas prices, a significant portion of the nation's industrial gas load is leaving the system for alternate fuels priced in a free market setting. In the past twelve months, between 20 to 25 percent of the past natural gas markets have disappeared, the vast majority in the industrial sector. As jobs are curtailed or lost, the price to the residential consumer has also been increasing and will continue to increase because pipelines may raise their transportation charges to achieve their guaranteed rate of return regardless of the number of lower units transported. This is already occurring as approximately 60% of recent consumer increases in the delivered price of gas is due to transportation and distribution costs. These extreme distortions are occurring under the current structure which is typified by monopoly control of pipeline purchasers over users of gas and monopsony control over producers. In order to remedy this problem, we support the development of equal access provisions as embodied in S.B. 615 with several modifications.

The current gas market is regional in scope and its structure does not work to the benefit of either producers or consumers. Extreme distortions are occurring under the current structure which is typified by monopoly control of pipeline purchasers over users of gas and monopsony control over producers. This structure is allowing lower priced gas not to be purchased, shut in or heavily curtailed while high cost gas is being purchased. It allows the pipeline purchasers' production affiliates to be given preferential prices and takes to the detriment of unaffiliated producers and consumers. It allows guaranteed returns and 100% cost recovery for pipeline purchasers regardless of their prudence in gas contracting while producers and consumers suffer the consequences. No other commodity is marketed in this fashion and no other commodity sees rapidly escalating end user prices during times of oversupply. This is more than a casual relationship.

The gas market needs to become national in scope and prices should be determined by direct negotiations between consumers and producers. Our proposal for equal access will not add to any price spike now or in the future. Rather, pipeline systems and consumers now saddled by very high cost gas will have an opportunity and incentive to seek this lower cost gas. The following legislative remedy should be included in this act.

Identify "Equal Access" categories of gas which would be small in volume at first but increase over time. Equal access gas would be available to be bought by any purchaser, such as a distribution company, an industrial end user or other pipeline at a distance. Shipment of the gas would be mandatory by all pipelines (interstate and intrastate), and distribution lines in between by payment of a reasonable and regulated tariff. This "Equal Access" gas should at a minimum include:

a. All new gas drilled and produced or contracted for after a certain date, such as 1/1/83, regardless of its current contract dedication,

b. all gas at the end of its primary contract term,

c. all gas released by exercise of market out or similar contract clauses,

d. all gas as to which the purchaser tries to force an uncontracted for reduction in price without producer approval, and

e. all gas under existing contracts subject to "market out" or price modifications by the purchaser made possible by existing or future legislative or administrative acts.

Pipelines could be allowed to continue to purchase all types of gas, including this category of gas, but once bought by another purchaser, such as another pipeline, a distribution company, or an end user, the pipeline would be required to transport that gas. The regulations that presently discourage transportation of nonpipeline-owned gas would have to be loosened to allow the pipeline to receive a just and reasonable tariff for that transportation service. These tariffs could be established in the same manner as the transportation tariff for other common carriers such as crude oil pipelines, railroads, etc. To the extent pipelines are required to transport gas for others, they could apply for and receive decertifications of existing service obligations.

Other considerations of the modification in the transportation system should include:

-- Pipelines subject to these common carrier provisions would exclude gathering systems which would be defined as facilities that are field operations only and do not purchase gas for resale and that did not use rights of eminent domain or condemnation in building their system facilities.

-- Modify NGA provisions that discourage transportation of gas owned by others. A sufficient but reasonable shipping tariff should be allowed.

-- Pipelines should be required to take ratably across their system from all gas sources, their own, purchased from others, or gas being shipped by others under the common carrier provisions.

To prevent abuse of the monopsony--the monopoly power of the pipelines--the following pricing amendments should be made.

1. Pipelines should be allowed, on first-sales gas, to pay their affiliates or affiliates of other pipelines, prices for each NGPA category of natural gas, regardless of the price-controlled status of the category, which do not exceed the lowest single price paid to any one unaffiliated producer on their system. (Not the highest, as law currently allows.)

2. Previously classified cost of service gas should be retained in that category and not allowed to receive first sales treatment as interpreted in the Mid Louisiana decision. Consumers bore the risk of cost of service investments and should receive the benefits.

Although the administration's bill begins to address the need for developing a system of equal access, there are several serious weaknesses we believe the Congress should remedy. The areas of weakness are:

1. S.B. 615 does not currently include intrastate pipeline systems under the contract carriage requirements. This oversight means that producers will only be allowed access to an intrastate system if they are marketed out first. The problem of concern then to both producers and consumers is that any new gas discovered, which may be cheaper, will not be eligible for transportation to an end user directly. Rather, it would have to be dedicated to that pipeline and the possibility exists wherein that cheaper gas would not be taken because the pipeline already has all the gas it needs to meet its delivered gas obligations.

   Additionally, by leaving the intrastate systems out of the contract carriage mechanism, a situation will be created where intrastate pipelines could frustrate attainment of the administration's access provisions. This could occurr because an interstate pipeline company could also create an intrastate subsidiary as a buffer between itself and the producers. As such, producers who could obtain contract carriage from interstate pipelines would be effectively shut out from that opportunity because they could not get their gas to the interstate pipeline through the intrastate pipeline which connects the two (producer and interstate pipeline).

2. Under the administration's proposal, intrastate pipelines may go outside the state, contract for gas supplies and mandate the interstate pipelines to carry that gas back to their market. We believe this is patently unfair to the interstate pipelines and that this provision should cut both ways.

3. The bill provides that when a producer is marketed out by a interstate pipeline company, that pipeline must transport the producers gas to a final market at an incentive transportation cost. This provision provides a strong mechanism for facilitating the development of direct access markets. However, the weakness in achieving this goal exists when a producer must transport his gas through more than one interstate pipeline to get it to final market. This weakness exists because the second pipeline (which was not previously under contract to the producer) is not as strongly obligated to transport the marketed out gas at an incentive price as the first pipeline. This dilemna should be addressed by requiring second or third, etc. interstate pipelines to meet the same transport obligations of the first one if the final market is only reachable through such a transportation connection.

4. Under S.B. 615, an interstate pipeline company must transport an amount of access gas that equals the highest 12 month average out of the past 36 months volume. A consideration that should be addressed is the situation with gas wells that become eligible for incentive price transportation, but have not been operating for the past 36 months.

5. A major impediment to the consumer receiving lower priced gas under the administration's access provisions is the continuation of minimum purchase obligations by the distribution companies to the pipelines. Because elimination of minimum purchase requirements is not addressed, many distribution companies who would be potential markets for this lower cost gas will be precluded from purchasing it due to these obligations. A distribution

company will not be willing to buy lower cost gas from a producer if they are still mandated to pay for some volume of higher priced gas from the pipeline company.

6. A provision should be developed which will insure that interstate pipeline companies may not discriminate against non-affiliated producers in their contract renegotiation efforts that may occur during the interim. Under the current proposal, a pipeline could renegotiate its affiliates 104 gas contracts upwards. This renegotiated price would go into the proposed cap and could thereby further reduce the price paid to non-affiliated producers who renegotiate after the lowered cap price is in place.

Equal access is critical in developing any long term soluation to today's problems. Our industry must have 100% equal access in any proposed legislation in order for the industry to survive and to continue to develop adequate supplies. It is critical in our support of this bill.

Next to the equal access provisions outlined, we are vitally concerned about the pricing mechanisms proposed in S.B. 615 that would cover the market place until 1/1/86. In reviewing these proposals IPAMS applauds the movement to total decontrol of wellhead pricing by 1/1/86 incorporated in S.B. 615. The NGPA was enacted to remedy the growing imbalance in supply and demand of natural gas cuased by acute shortages in the interstate markets during the mid-1970's. In addition, the NGPA recognized the merits of deregulating wellhead pricing and the necessity of providing incentives to encourage producers to undertake the more costly and more risky exploration efforts for unconventional natural gas reserves to assure adequate gas supplies in succeeding decades.

The acceleration of removal of NGPA wellhead price controls incorporated in S.B. 615 for contracts executed or amended after the date of enactment is a sound concept in carrying out the intent of NGPA. However, IPAMS is extremely concerned that by allowing "old" domestic gas contracts which are renegotiated to be included in the price cap formula will cause serious consequences to the industry and consumers. If renegotiated "old" gas is included in the forumula while imports and 107 gas is left out, the gas cap will unduly force down the price of conventional 102 and 103 gas below a legitimate market clearing level. As market prices have already fallen on 107 gas, most exploration is now and is projected to continue in the conventional gas ranges of 102 and 103 to replace old reserves. This proposed rollback that will occur under the current formula will cause an undue financial burden on those producers who already contracted at a reasonable price to absorb the price shocks of all other categories of gas under the NGPA. As a result, if implemented, drilling for 102 and 103 type gas will be totally discouraged leaving the nation with a drop off in reserve replacements, a critical shortage of gas by 1986 similar to that experienced in the mid-seventies and a substantial price spike after 1/1/86. To promote a smooth and orderly progression to total decontrol, a more realistic gas cap formula must be developed. IPAMS agrees with the philosophy that market price should enter into the evaluation of risk involved in exploration efforts and that, as known conventional supplies dwindle, market force will indicate the price incentive necessary to explore in new areas.

IPAMS believes that the concept of basing the new maximum lawful price of regulated gas on the lesser of the gas cap price set by the volume weighted average price of deregulated gas or the applicable NGPA price should alllow controlled gas prices to reflect, on a gradual basis, a market clearing price. However unless imported gas is included in the price cap, the nationwide gas cap price cannot be as completely market responsive. Imported gas contracts must be honored and are necessary, particularly in IPAMS states, to meet winter demand. The higher the percentage of imported gas in a given pipeline's mix means the less flexibility that pipeline will have to extend a market clearing price to its domestic producer under renegotiated or amended contracts due to limitations on the pipeline's ability to pass through costs under the bill's purchased gas costs formula. Because of an inability to negotiate a true market price, the producer will receive an artificially low decontrolled price which will be transmitted into a lowered gas cap price. Gas currently priced under the incentive categories of NGPA will experience downward pressure leading to decreased drilling and possible price fly ups for the consumer in 1986. In addition, exploration efforts that could take place in the United States may be directed outside of the nation.

The proposed formula for purchased gas costs adjustments is also too inflexible with regard to the natural decline of the "old" gas mix in a pipeline and its replacement by naturally higher priced conventional gas. Without greater flexibility, the replacement of "old" cheaper gas by conventional priced 102 or 103 gas in a pipelines mix will force the price rollback to be totally born by the producer. This is an unfair pricing policy that would occur from normal event of "old" reserves naturally declining in their percentage of the pipeline's mix.

Another area of grave concern to IPAMS is the inclusion in the bill of the provision allowing the FERC to retain the right to lower the NGPA incentive price for gas produced from designated tight formations. The Rocky Mountain states currently produce an estimated five percent (5%) of its total gas production from tight sand formations. The majority, if not all, of the gas produced from tight sands is subject to contracts containing market or economic "outs". Typically, these market outs are tied to an alternate fuel cost. Throughout our area, during the past twelve (12) months, purchasers are invoking these market out provisions for tight sands prices in response to market signals. It is IPAMS belief that these market signals will continue to dictate tight sands pricing and the intervention of the FERC in reducing the price is contrary to the intent of NGPA and outside the scope of the authority of the FERC.

S.B. 615 takes the right approach in calling for the elimination of the Powerplant and Industrial Fuels Use Act and the incremental pricing provisions in Title II of the NGPA.

The Powerplant and Industrial Fuels Act of 1978 (Fuel Use Act) and the incremental pricing provisions in Title II of NGPA were enacted on the erroneous premise that natural gas reserves were dwindling. Under the Fuel Use Act, construction of any new natural gas boilers by utilities or industrial users was prohibited and existing boilers were to be converted to coal by 1990.

The incremental pricing provisions of the NGPA require that interstate pipelines and local distribution companies pass through certain portions of their natural gas acquisition cost to industrial users in the form of incremental price surcharges. The surcharges may not exceed the appropriate alternative fuel oil cost to the facility.

The measures implemented by these laws were intended to encourage the use of coal and assure "small" consumers of continued and adequate supplies of natural gas. However, the costs of converting to coal have proven prohibitive to many large industrial boiler users. Instead, these users have elected to switch to oil, a less costly option.

In closing, IPAMS supports the efforts of this administration in moving towards a free market that will create a natural gas system of fair prices and stable supplies. As we have seen in the oil, airline and telephone areas, deregulation of natural gas is a concept that when fully implemented, will work to the benefit of consumers. We ask that you support the administration's bill with the changes we have recommended today to achieve this goal.

Thank you for this opportunity.

Senator MURKOWSKI. Thank you very much, Ms. Wallace. Our next panelist will be Mr. Rex Fuller, chairman, National Energy Policy Committee, Texas Independent Producers and Royalty Owners.

We welcome you to the committee and ask that you proceed with your testimony, Mr. Fuller.

Mr. FULLER. Thank you, Mr. Chairman.

STATEMENT OF REX FULLER, CHAIRMAN, NATIONAL ENERGY POLICY COMMITTEE, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION

Mr. FULLER. My name is Rex Fuller, and I am an independent oil and gas producer from Lubbock, Tex. I am chairman of the National Energy Policy Committee of the Texas Independent Producers and Royalty Owners Association [TIPRO], and I am testifying today on behalf of our 5,400 members, which include a majority of the more than 6,000 independent producers in the State of Texas.

My remarks will be abbreviated and we have submitted full copies for your consideration;

In Texas, the number of active drilling rigs has dropped by 25 rigs per week since January 1, 1983: Nationally, the rig count has dropped by over 80 rigs per week, setting the stage for another artificial natural gas shortage to come.

The cure is a greatly improved free market atmosphere which we believe S. 615 begins to address. There are several objectives producers need to insure competitive, adequate and timely drilling activity in the future.

They need a fair opportunity to produce. They need equal access to existing markets. They need a commodity value for gas sold.

They need a competitive marketplace, and they need to minimize cash flow uncertainties.

These are some reasons that we are anxious to work with this committee and with the entire Congress to solve the problems that natural gas controls have caused.

We agree with Secretary Hodel who said that no consumer of natural gas should be forced to purchase supplies at a high price when lower priced supplies are available.

Since many objectives described above are addressed in this administration's bill for natural gas deregulation, TIPRO lends support to S. 615.

We do seek important modifications to this measure. S. 615 calls for total decontrol on January 1, 1986. This may justify some potentially serious and complicated regulations outlined in the bill to cover the transition period between its passage and that date.

However, an extension date beyond January 1, 1986 would make this proposed legislation unacceptable to our association's membership.

Transition devices leading to decontrol should be carefully designed to avoid the unnecessary wellhead price adjustments, while assuring continuation of the industry drilling activity needed to protect against future supply shortages.

This cannot be achieved if wellhead prices existing in prospective production from exploratory new development in high-cost wells are subject to an undue rollback.

Producers of new gas should have full opportunity to seek the true market clearing price, whatever that may be. S. 615 does not provide for that opportunity.

The proposed transition wellhead price ceiling should be based solely on the weighted average price for new gas supplies.

In conclusion, the renegotiated prices for old contracts defeats that avowed purpose for setting a true market price for new gas.

The objective should be to determine true market value of gas supplies, not to test the veritability of various industry segments to renegotiate contracts governing the control supply.

The transition period will probably result in lower prices for new gas production regardless of what controls prevail.

TIPRO simply urges avoidance of a control design that depresses prices at a still lower level because a maximum level of drilling activity is more likely under true market conditions.

We perceive another problem in the limitation in S. 615 on purchased gas adustments by pipelines in the FERC ratemaking procedures;

This is a danger that the gas contracted under incentives provided by section 102, 108, perhaps 103 of the NGPA will suffer substantial price rollbacks, while only section 107 gas is protected from this probability.

Anticipation of such legislative treatment has possibly contributed to the current decline in drilling in Texas which is not 50 percent below last year's level.

TIPRO recommends changes in the transition cap, design and PGA restriction found in S. 615. Failure to do so could be a harsh blow to the independent producers, who are more active in maximizing new supply.

We find the administration's efforts to correct the serious problems of natural gas markets very commendable; We hope this commitee will use S. 615 as a means to effect true decontrol of natural gas as rapidly as possible, and we will resist pressure to turn this into another round of rate control that will thaw market signals.

Those signals are needed to reduce natural gas prices without bringing on another artificial shortage of natural gas.

Thank you very much.

[The prepared statement of Mr. Fuller follows:]

STATEMENT BY

Rex Fuller
for the
Texas Independent Producers & Royalty Owners Association

to the

ENERGY AND NATURAL RESOURCES COMMITTEE
U.S. Senate
March 11, 1983

My name is Rex Fuller, and I am an independent oil and gas producer from Lubbock, Texas. I am Chairman of the National Energy Policy Committee of the Texas Independent Producers and Royalty Owners Association, and I am testifying today on behalf of our 5400 members which include a majority of the more than 6000 independent producers in the state of Texas.

We appreciate the committee's calling this hearing to address the serious disorder in the natural gas market and thank you for the opportunity to be heard so soon after the Administration's submittal of a natural gas decontrol plan to the Congress last week.

INTRODUCTION

As an association, TIPRO has been consistently on record that the nation and its energy consumers will be best served by a free market for natural gas. Ever since the price controls were first imposed at the wellhead over 28 years ago, TIPRO has presented thousands of words of detailed testimony to the Congress and regulatory bodies, and repeatedly warned about market distortions and potential shortages caused by the artificial pricing of natural gas. Time after time as the regulations have become more convoluted, and the results have been the opposite of congressional intent, we have found ourselves saying "We told you so."

We believe that Secretary Hodel's basic plan for decontrol, which has been placed before you by the administration, contains a number of important, innovative ideas. We also believe there is room for improvement. But mostly we believe that the proposed bill can be worked into a new law under which we will never again find it necessary to say "We told you so", except in the most positive terms.

Texas producers consider themselves generally qualified to speak for gas producers everywhere, because the problems are generally the same for all. In Texas, we produce 35 percent of all the natural gas produced in the United States and 46 percent of all natural gas liquids. One-fifth of the nation's total supply is used within Texas. Our proven reserves of more than 50 Tcf represent over 25 percent of the nation's total reserves. Orderly natural gas markets are important not only to Texas producers themselves, but to the economy and well being of our entire State and to the United States. Natural gas provides 49 percent of all the energy needs of Texas, and some 78 percent of all the gas sold in Texas is used by industry and electric utilities which must rely on a long-term, dependable supply of natural gas.

In 1941 the United States had a 40.5 year supply of natural gas, based on proven reserves of less than 114 Trillion cubic feet and annual usage of 2.81 Tcf per year. By 1967, proven reserves had increased 2.5 times to an all-time high of nearly 293 Tcf; however usage rose to 18.7 Tcf so that our reserves then gave us only a 16.1 year supply. With price controls, which insured an unrealistically cheap consumer price, and very little incentive for the drilling of new wells, natural gas reserves then began a downhill slide until 1979 when they hit only 195 Tcf, at which time marketed natural gas production reached 20.47 Tcf leaving the U.S. with only a 9.5 year supply.

While we complained bitterly about the terms of the Natural Gas Policy Act of 1978, and warned that it contained the seeds to further complicate the natural gas market, we recognized that it did contain some pricing encouragements, and was responsible for a turnaround of declining drilling activity. Following 1979, the downward trend of reserve flattened and began to rise slightly, to somewhat over 202 Tcf, while usage has stabilized at a little over 20 Tcf, giving us a 10.5 year supply.

GAS MARKET DISTORTED

But the NGPA, formulated on the false premise that America was running out of natural gas, is now working against increasing the nation's ratio of reserves to consumption, at the expense of the nation's consumers. The disruptions in today's natural gas market have been caused by increasing layers of natural gas controls which prevent less expensive gas from reaching the market, and have artificially reduced the market for the resource.

It is a situation which has now reduced the drilling for new natural gas in Texas, setting the stage for another artificial shortage to come. Well over half of all the projected gas use in 1986 must come from new wells to be drilled between now and 1986 -- and they are not being drilled under today's conditions. In Texas, the number of active drilling rigs has dropped by 25 rigs per week since January 1, 1983. Nationally the rig count been dropped by over 80 rigs per week.

Our state officials are concerned too. The Texas State Employment Commission recently released a statement which said that for every job lost in the Texas oil industry, five jobs are lost in the rest of the Texas economy. This is placing an additional strain on our already-bankrupt unemployment compensation fund.

There are three basic reasons why natural gas prices are rising even while demand is declining:

First, the Fuel Use Act and NGPA incremental pricing requirements, along with the economic recession, have reduced the industrial usage of natural gas. Usage by industrial and commercial customers amounted to 62 percent of the total U.S. gas consumption last fall, and residential consumers used only slightly more than 15 percent of marketed production. When industrial use falls -- as the Fuel Use Act decrees it must -- those who remain on the system must pick up a disproportionate share of the transportation and delivery cost. This can create huge increases in residential bills. The producer does not get any more for his gas under these circumstances. Neither does it create more profit for pipelines and distributors whose charges reflect only the rate of return on their investment which they are allowed by law. The only impact is on the consumer who is paying dearly for the distortions caused by the current regulations as he picks up a larger share of those fixed charges now being apportioned to a smaller number of customers.

Secondly, old reserves of historic natural gas are being depleted by at least ten percent per year and must be replaced with higher cost gas.

The third factor is that much of the market is being serviced by increasing amounts of very expensive imported gas. We believe it is a travesty for much of the least expensive gas in the United States to be shut in by gas purchasers, while gas imports from Canada, Mexico and Algeria are being stepped up and command prices almost twice as high as the average prices allowed American producers.

It is extremely tempting for those of us who live with the growing problems caused by natural gas controls to simply say that the market problems can be solved by the simple expedient of abolishing all controls immediately and forever. We're probably guilty of proposing those kinds of solutions, and to a large degree we believe immediate decontrol would be the fastest cure. But we're also realists. After more than a generation of controls, some of the practices in the industry are too firmly meshed with the gears of controls for immediate dismantling. Furthermore, we are painfully aware that many in the Congress do not understand the relationship between the separate segments of the natural gas industry and are vocally opposed to fewer wellhead controls.

We hope to work with this committee in solving these political problems. Removal of price controls has been proven again and again as the best way to eliminate inefficiencies and bring about lower prices. As the last major commodity still constrained by the politics of control, we believe it is time that consumers reap the benefits of lower and more stable prices that the removal of complex wellhead price controls will bring.

This admirable goal, if achieved on a continuous basis, would eliminate the devastating side effects of periodic gas surpluses and shortages that are capable of disturbing virtually the entire nation's ecomony. Yet, it will remain illusive so long as national gas energy policy fails to encourage orderly and sufficient exploration for and development of natural gas reserves.

This places the producers, as a class, in an extremely responsible position, for without their collective finding effort tailored to the nation's need, the goal of an orderly supply-demand balance over extended periods is unattainable. Since the nation's thousands of gas producers are not in position, legally or practically speaking, to organize for purposes of achieving this goal, the only alternative is a greatly improved free market atmosphere which we believe S.B. 615 begins to address.

Producers do not have such an atmosphere under the complexities of the Natural Gas Policy Act and the continuing residual controls of the Natural Gas Act. "Competitive decisions" today are regulation oriented, not free market oriented. With comparable quality gas priced under some 28 different regulatory classifications that cause over 1000 percent variation in price received by the producer, the situation will not change.

Further, such an illogical array of pricing assures an unequal treatment of all entities -- the producer, pipeline, distributor and consumer -- in a magnitude guaranteed to generate political interference. Thus far, such interference has only led to further degeneration in gas energy policy.

From the producers' standpoint, there are several changes which must be made to assure their competitive, adequate and timely drilling activity in the future. In addition to eventual price decontrol that moves pricing from a regulatory to a competitive base as soon as feasible, the changes include:

1. **Fair opportunity to produce.** In times of surplus, all producers require purchase of a reasonable proportion of their production capacity. Without it, insufficient funds are available to service debt and the expense of vital drilling activity. When some producers are at 20 percent or less of their deliverability while others are enjoying close to 100 percent, optimum drilling activity in the industry is impossible. Unfair shut-in capacity burden is the most devastating economic blow there is to the active producer. State ratable take regulation, a legislative environment in which reasonable take or pay provisions in producer contracts are possible and international agreements for U.S. natural gas imports based on need can help assure fair distribution of available market among producers.

2. **Equal access to existing markets.** Producers should have reasonable opportunity to shop for customers, and consumers should have the same option. As it stands now, producers are captives of natural gas pipelines, which dictate the amount purchased and the price within regulatory requirements. While pipelines are probably in the best position to market natural gas and are needed to direct market traffic, there should be opportunity for peripheral sales between producers and end users with the pipelines acting as service conduits with reasonable transportation charges. Such opportunity for the producer is also needed to offset the one-sided "market-out" rights established by pipelines in some contracts with producers as well as to displace eventually "off-system" sales that pose unfair competitive practices in various geographical areas of the nation.

3. **Commodity Value for gas sold.** Pending total pricing decontrol and subject to contractual restraints freely arrived at between buyer and seller, producers should have freedom to seek current competitive value for their natural gas production. Regulatory environment should be adjusted in such a manner that producers can price their product, regardless of vintage, to levels that are competitive with alternate fuels. Comparable natural gas, like housing and other commodities, should be free to seek current value. Aside from economic logic, such freedom is justified in terms of providing the cash flow necessary to replace depleted reserves at current finding costs.

4. **A competitive marketplace.** Aside from arbitrary price controls, the major stumbling block to achieving this change are federal measures that restrict use of natural gas by potential end users. All such restraints should be eliminated; alternate fuel competition should be the sole determinant of what energy consumers use.

5. **Minimizing uncertainty concerning cash flow.** Independent producers, and especially their bankers and investors, are totally dependent on cashflow at the wellhead in order to secure financing for their prospects. Take-or-pay clauses were developed in order to provide the predictability necessary for such financing. The clauses guarantee the producer a reasonably stable cash flow by sometimes requiring advance payments for gas to be delivered free of charge in the future. DOE studies

> show that take-or-pay charges account for no more than 4 percent of residential consumer prices. Yet for the individual producer faced with fluctuating demand for his gas, these prepayments serve to smooth out the market's peaks and valleys in a way which enables loan obligations to be met. Therefore, reasonable take-or-pay provisions, even during periods of oversupply, are in the best long-term interest of consumers.

These five objectives tend to serve the bottom line for the benefit of producers, pipelines, distributors and consumers since they all depend heavily on adequate motivation for the producers to replace depleted reserves in an orderly fashion.

These are some of the reasons that we are anxious to work with this committee, and with the entire Congress to solve the problems that natural gas controls have caused. The solutions we seek are those which will be in the best interests of both producers and consumers of natural gas. We agree with Secretary Hodel who has said that no consumer of natural gas should be forced to purchase supplies at high prices when lower priced supplies are available.

TIPRO POSITION ON S.B. 615

Since many of the objectives described above are addressed in the Administration's bill for natural gas deregulation, TIPRO lends support to the Senate Bill 615, as opposed to other control and decontrol measures now before this Committee and the Congress, but does seek important modifications to the measure. The proposed end result is total decontrol on January 1, 1986. This tends to justify some form of the potentially serious and complicated regulation design outlined in the bill to cover the transition period between act passage and that date. At the same time, however, any extension date beyond 1-1-86 would make this proposed legislation unacceptable to our association membership.

How to get there from here with a minimum of upheaval is extremely important to the best long range interest of both consumers and producers. Transition devices leading to decontrol should be carefully designed to avoid unnecessary wellhead price adjustments, while assuring continuation the industry drilling activity needed to protect against future supply shortages.

In our opinion, this objective cannot be achieved, if wellhead prices for existing and prospective production from exploratory, new development and for high cost wells undergoes undue rollback. Producers of new wells, along with wells drilled under the Natural Gas Policy Act, should have full opportunity to seek the true market clearing level for price, whatever that may be.

Senate Bill No. 615 does not provide that full opportunity. The proposed transition wellhead price ceiling should be based solely on weighted average prices for new gas supply. The inclusion of renegotiated prices for old contracts defeats the purpose of setting a true market price for new gas. The objective should be to determine true market value of the gas supply not the varied ability of industry segments to renegotiate contracts governing a controlled supply.

Market conditions anticipated for the transition period will probably result in lower prices for new gas production, regardless of what controls prevail. TIPRO simply urges that control design depressing prices at a still lower level be avoided in the interest of maintaining a maximum level of drilling activity as justified by true market conditions. Hopefully, future shortages and their consequences can thereby be avoided.

Limitations in Senate Bill 615 on purchased gas adjustments by pipelines in the FERC rate making procedure pose another problem. There is danger that gas contracted under incentives provided for by sections 102, 108, and perhaps 103 of the NGPA will suffer substantial price rollback, while only Section 107 gas is protected from this probability. This could cause serious economic and development planning problems for the nation's active explorationists that, in turn, would bring new drilling to a virtual standstill. Anticipation of such legislative treatment has already cut gas drilling in Texas, for example by some 50 percent below last year's levels.

TIPRO recommends change in the transition price cap design in the PGA restrictions found in Senate Bill 615. There should be greater recognition of non-Section 107 gas supply developed under NGPA's incentive provisions. Failure to do so would result in unduly harsh attack on those independent producers most active in maximizing new supply.

To put it in another way, the wrong industry segment would be called on for a disproportional front end burden as the price to pay for eventual decontrol. The inevitable result would be to aggravate the problem of shortage in the long term. Consumers would be poorly served by such policy.

We reiterate that we find the Administration's efforts to correct the serious problems in natural gas marketing very commendable indeed. We sincerely hope that this committee will use this bill as a means to effect true decontrol of natural gas prices as rapidly as possible. We hope the committee will resist pressures to turn this into another round of recontrol that will thwart market signals. Such signals are needed to reduce natural gas prices without bringing on another artificial shortage of natural gas. In short, we never again want to be in a position of saying "I told you so".

Respectfully submitted
Texas Independent Producers & Royalty Owners Association
1910 InterFirst Bank Tower
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Senator MURKOWSKI. Thank you very much. We appreciate your testimony, Mr. Fuller. Our next panelist will be Mr. John McMillian, Northwest Energy Co., and we welcome you to the committee.

Senator FORD. Excuse me. We have a vote on the Senate floor, and we will be leaving here shortly, and I am sure the chairman will be back.

I have legislation that will be up shortly this afternoon and will prevent me from coming back for a while. I wonder if it would be of any objection to submitting questions to this particular panel in writing for answers within about 1 week.

I apologize for having to do that, but I would like to answer those questions, and I will not be able to be here.

Senator MURKOWSKI. Senator Ford, I understand that questions can be submitted through tomorrow for inclusion and submission of the witnesses.

Senator FORD. OK, I think, and I apologize to the panel.

Senator MURKOWSKI. Thank you, Senator Ford.

Mr. MCMILLIAN. I am going to miss you, Senator Ford. I am going to give you different answers to some of the other questions you asked earlier.

Senator FORD. When I was intending to ask you.

Senator MURKOWSKI. Excuse me.

Mr. MCMILLIAN. Do you want us to go ahead, Mr. Chairman?

Senator MURKOWSKI. Excuse me. We are going to have to make some decisions here on how we are going to vote.

We are going to keep going because there appears to be some type of mutual debating society that is about to take place upstairs that will take Senator Ford and, I think, Senator Nickles.

Are you going to debate each other? I see. Well, that leaves me here. With that, we will continue until I have to go and then recess until I can get back.

Senator NICKLES. I would like to hear at least part of Mr. McMillian's statement.

Senator MURKOWSKI. Mr. McMillian, please proceed, and I apologize for the two or three interruptions, and you have awakened us with your cough, so we are——

Mr. MCMILLIAN. It was a good cough.

Senator MURKOWSKI. It was a good healthy cough.

STATEMENT OF JOHN McMILLIAN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, NORTHWEST ENERGY CO.

Mr. MCMILLIAN. Northwest Energy operates two pipeline systems. The first one we acquired in 1974 serves the Pacific Northwest portion of the United States.

At that time when we obtained the Northwest Pipeline System, we changed our contracting policies. We have no take or pay contracts of any magnitude.

We have market adjustment or market-out clauses in 85 percent of our gas contracts. Since April 1982 we have lowered the price of gas to our consumers in the Pacific Northwest by $140 million, or nearly 46 cents per thousand Btu's, and we are proud of this record and we are proud that we were able to meet the economical conditions and the market conditions that exist in the Pacific Northwest.

We do have one problem—that is Canada. About 40 percent of our gas reserves derive from Canada. We have cut back our volumes of gas from that source by 30 percent.

We have notified them that we were cutting back further unless the price is adjusted to what we feel will enter the market of the Pacific Northwest, which is around $3.40, $3.50.

We operate another system, and the reason I wish that Senator McClure was here is because we serve his State so well and lowered the gas prices, I think that maybe he doesn't have a real good overall view of what is happening in the country, and so that is why I wanted to explain Northwest Central, which is based in Oklahoma City.

Senator MURKOWSKI. I am sure your remarks will be passed on to him.

Mr. MCMILLIAN. Please let him know this because I think when he hears this story, it is a little different story.

And we have big problems with the Northwest Central Pipeline System. Our gas is $4.66 entering the marketplace and it competes with No. 6 fuel oil at $4.

We have lost a big portion of our industrial markets. Our volumes have declined on this system of 30 percent from 1982 to what we project in 1983, and they might decline more than 30 percent.

The reason for this increase—and we have one of the largest supplies of old gas and cheap gas in the United States.

Sixty-eight percent of our gas reserves are so-called old gas, and a lot of it is from the Hugelton field about 80 cent gas, average pricing from Hugelton field of 80 cents.

But we also have severe and very restrictive take or pay contracts with some tight gas in Wyoming and other areas where that gas, when it comes into our system and goes to the marketplace, is about $8.

And so we are in the position of curtailing 80 cent gas from Hugelton field and selling $8 Wyoming gas to the Kansas customers, and of course this upsets them when we are not buying the gas from Kansas and selling them Wyoming gas for $8.

But what bothered us so much was we were losing all our industrial markets, and of course we were losing about 18 percent of the residential users of gas in the Kansas City area, who cannot or will not pay their gas bills.

And so we think we have a crisis in this area in that we are losing our gas market. We have tried to renegotiate since we took over the system in November with major producers.

We have not had success. And the first attempt to negotiate with one major oil company, they came back with five points to enhance their revenue rather than lower the cost of gas to our service area.

So we haven't had success in negotiating contracts, and I don't think we will unless we have some legislative help from this Congress.

We don't like the Hodel bill. We think it is a bad bill. We think it is a major oil company bill. It hurts the consumer. It hurts the pipeline companies. It hurts the distribution companies, and the only ones that really benefit from this bill are the ones that own old gas.

In our particular area, about 85 percent of the major oil companies are owners of the old gas that we have under contract.

And so that is the segment of the industry that we see it helping the most is the major oil companies. We don't see how it helps to increase and give incentives to drill new gas production when you lower the price of new gas, and the administration admits this.

Mr. Nickles, we think that you are going to create two market systems with the Hodel bill, of it passes like it is.

You will have an interstate/intrastate system like you had in the early seventies.

Senator MURKOWSKI. Mr. McMillian, I must interrupt your testimony. I apologize, but we have to vote.

There will be a recess of about 5 minutes and we will then reconvene.

[Whereupon, a brief recess was taken.]

Senator MURKOWSKI. I would ask the panel to return to their respective positions. I will terminate the recess.

I would ask that John McMillian please proceed with his testimony, which I apologize for interrupting, but the necessity of a vote I guess overrode his testimony.

So with that introduction, I will ask him to proceed again.

Mr. MCMILLIAN. Thank you, Mr. Chairman. I don't know whether I mentioned, but we don't like this bill.

Senator MURKOWSKI. We do recall you making reference to that.

Mr. MCMILLIAN. And we are against the deregulation of old gas. And if all the cards were thrown up in the air and if all the contracts were wiped clean one day and we had to have them tomorrow, but we had to enter—make our gas competitive and the old gas was elevated to a price to clear the market in our area today, we would be looking or facing a price increase in the Northwest Pipeline System of $177 million in 1983 and over a $5 billion impact over the life of the gas reserves for the Northwest System to the consumer.

The Northwest Central System would be more severe than that because we have a larger percentage of old gas, but the price—it would increase the cost to the consumer by $204 million in 1983 and $8.5 billion over the life of the gas reserves.

So we feel like there is no consumer protection in this bill, and as Mr. Hodel, Secretary Hodel claimed or stated, that the squeeze on the pipeline transmission companies were the lynchpin of this bill, then this bill does not have a lynchpin because our ability to negotiate these contracts or renegotiate these contracts has been very limited, and we would have very little leverage to negotiate these contracts.

We think that with the pressure being put upon the industry, like 18 percent of the gas consumers in Kansas City cannot pay their gas bills, will not pay them this year, and we understand from Philadelphia it is over 25 percent and other cities are experiencing similar percentages, that you will be facing a crisis where some bill, some legislation will be passed.

We feel the most important things to correct to lower the gas prices today would be a correction on the take or pay clauses in contracts with a limitation or eliminating the gas price indexing.

Mr. Chairman, I appreciate the opportunity to testify before you today and will be glad to answer any questions.

[The prepared statement of Mr. McMillian follows:]

PREPARED STATEMENT OF
JOHN G. MCMILLIAN
NORTHWEST ENERGY COMPANY

BEFORE THE COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

MARCH 11, 1983

My name is John G. McMillian. I am the Chairman of the Board and Chief Executive Officer of Northwest Energy Company, headquartered in Salt Lake City, Utah. Northwest Energy Company has two wholly-owned subsidiaries which are interstate natural gas transportation companies -- Northwest Pipeline Corporation, which serves 19 distribution systems in the States of Washington, Oregon, Idaho, Wyoming, Utah, Colorado and New Mexico; and, Northwest Central Pipeline Corporation, which provides wholesale gas service to approximately 500 cities and towns and direct sales to industrial customers in the States of Kansas, Colorado, Missouri, Nebraska, Oklahoma, Texas and Wyoming.

I have served as Chief Executive Officer of Northwest Pipeline Corporation since 1974. I have served as Chief Executive Officer of Northwest Central Pipeline Corporation since November 15, 1982, following the acquisition of that company's predecessor, Cities Service Gas Company, by Northwest Energy on November 12, 1982.

As the Committee is aware, Northwest Energy also has a deep and abiding interest in the construction and operation of the

Alaskan Natural Gas Transporation System, which will be built to provide a transportation system for the movement of the vast natural gas reserves of Alaska to the lower 48 states. And finally, Northwest Energy, through its subsidiaries, is the largest U.S. importer of Canadian gas into the United States.

I am prepared to respond to any questions which the Committee might have with respect to the Alaskan project and our Canadian imports, but I would like to address my prepared remarks to the impact of legislation upon our principal business: that of providing reliable and adequate service to the consumers dependent upon the interstate movement of natural gas from the point of production to our service areas in the Midwest and Pacific Northwest. While legislation may have profound effects on the Alaskan Project, and on Canadian imports, my concerns today lie in another area. My concerns are for the present and future customers of Northwest Pipeline and Northwest Central who need price relief today, and reliable service today and tomorrow.

I am accompanied by Mr. Rush Moody, Jr., a partner in the Washington law firm of Akin, Gump, Strauss, Hauer & Feld. Mr. Moody serves as regulatory and legislative counsel to Northwest Energy and its interstate pipeline subsidiaries.

At the outset I wish to thank the Chairman and members of this distinguished Committee for allowing me to present my views on the current crisis facing the natural gas industry, the Administration's legislative initiative, and the legislative provisions which I believe are essential if this industry is to provide residential consumers with reliable and dependable gas supplies at reasonable prices and industrial users with gas priced competitively with alternate fuels.

The current crisis is one of excess supply and declining demand, coupled with rising gas acquisition costs. The crisis exists because the natural gas industry is unable to respond to a rapidly changing market. Our inability to hold prices down even when the marketplace is telling us that we must do so is the product of pricing rigidity born in the statutory price structure established by the Natural Gas Policy Act of 1978, and nurtured through the contracting practices emanating from the events that gave rise to that legislation as well as the NGPA itself. I am sure this Committee will recall a different crisis only a few years ago, one of inadequate supply and curtailment of high priority gas users. This cycling between deficiencies and excesses requires some historical perspective in which to assess the Administration's proposal and my response thereto.

1. Background

The interstate natural gas transmission industry was built on two assumptions -- (1) that interstate pipelines would purchase under long-term contracts sufficient gas reserves, and provide reliable transportation facilities sufficient to meet the immediate and long-term collective needs of their distribution companies and direct industrial customers; and, (2) that a pipeline's fixed and operating costs would be equitably shared by large volume industrial users who have year-round needs, and residential users who need gas principally during the heating season. It has always been obvious that natural gas transportation and distribution costs cannot reasonably be recovered from residential customers alone -- industrial sales are mandatory if pipelines are to provide adequate and reliable service for residential customers at a price within their means.

In the early 1970's the interstate transmission industry faced its first crisis, that of curtailment of services due to inadequate gas supplies. Supply shortages were experienced only by interstate pipelines, and resulted from the inconsistent regulatory treatment of the interstate and intrastate gas markets. Because there were no wellhead price controls applicable to intrastate gas sales, but wellhead price controls were applied to sales to interstate transmission companies, the majority of new gas supplies were sold intrastate to avoid both price and nonprice federal regulation. Natural gas producers sold to interstate pipelines only as a last resort.

Industrial customers were the first to be impacted by curtailment. By the winter heating season of 1976-1977, however, the shortage condition had worsened to the point that emergency legislation was required to ensure adequate and reliable service to residential consumers. Congress responded by rapid passage of the Emergency Natural Gas Act of 1977. Thereafter Congress began deliberations on a comprehensive legislative solution to the problems caused by the dual market, including the decline in drilling and reserve additions and the ever-increasing curtailment by interstate pipelines of essential users of gas.

The result was the enactment of the Natural Gas Policy Act of 1978. The NGPA has succeeded in stimulating additional drilling and discoveries, and eliminated the disincentive to make commitments of new reserves to interstate pipelines. In the first few years following enactment of the NGPA, however, interstate pipelines continued to experience serious gas shortages, and desperately needed to replenish their reserve base to avoid projected curtailment of residential users in the 1980's. The gas short interstate pipelines had little or no bargaining leverage in their gas acquisition negotiations with natural gas producers. Since the NGPA placed a ceiling on the prices that could be paid for most gas -- and producers had the bargaining power to insist on and receive these price ceilings -- competition for new supplies focused primarily on non-price contract provisions, particularly (1) "take or pay" provisions which require that pipelines take a specific percentage of daily deliverability -- as much as 90 percent; and, (2) escalation provisions ich tie the gas sales price upon decontrol to as much as 120 percent of the price of fuels competitive with natural gas.

Gas short pipelines who had insufficient daily deliverability to meet the contract demands of their customers then had no choice but to accept these terms if they were to fulfill their public utility responsibilities of providing reliable and adequate service. The only alternative was increased service interruptions. And, acceding to these terms was viewed then as an acceptable risk because industrial demand for gas was strong, oil prices were continuing to escalate, and the NGPA provided for rolled-in pricing capabilities since price controls would remain on "old" flowing gas beyond 1985.

In hindsight, however, the NGPA had three flaws: (1) its pricing structure is premised on the assumption that oil prices, and thus the price of fuels in competition with natural gas, would continue to rise in real terms through the 1980's thereby ensuring that natural gas could always be priced competitively to the industrial user; (2) its incremental pricing provisions were incapable of preventing the payment of prices in excess of market clearing levels for certain new gas, especially when the alternative was continued curtailment of supplies; and (3) its future rate structure was premised on the belief that natural gas was so under-priced historically that automatic, monthly escalations in price -- in excess of the rate of inflation -- were necessary to permit natural gas prices to rise to market clearing levels.

2. Current Problems

Despite a depressed economy, declining fuel oil prices, and excess supply, natural gas prices continue to escalate. Without a legislative change there is nothing to break this upward trend, since these escalations flow inexorably from the provisions of existing wellhead purchase contracts executed when pipelines had no little or bargaining leverage, and from the statutory price structure established under the Natural Gas Policy Act.

To put the problem in perspective, the average price of natural gas to large industrial users located in the Northwest Pipeline and Northwest Central market areas is presently well above the price of alternate fuel -- primarily No. 6 oil. Sales on both systems have declined dramatically. For example, Northwest Central's sales have declined from 383 Bcf in 1980 to 294 Bcf in 1982 and are projected to fall to 233 Bcf in 1983. Northwest Pipeline's sales have fallen from 332 Bcf in 1980 to 282 Bcf in 1982 and are forecast to decline in 1983 below the 1982 level. Based on the most recent actual sales volumes during the month of January and February of this year, both Northwest Central and Northwest Pipeline are forecasting 1983 sales at levels substantially below that of 1982 levels.

There are a number of factors causing this precipitous decline in sales. A deep and prolonged economic recession, warmer than normal weather, and increased conservation all play major roles. But at the heart of the problem is the inescapable fact that natural gas has been priced out of the industrial market for those industrial users who have the ability to switch to alternate fuels.

So severe have been the consequences of escalating natural gas prices, that unless the pattern is broken, and indeed prices are rolled back to the level of competitive fuels, the gas industry will be near collapse. As more industrial concerns recognize that natural gas prices are escalating while residual fuel oil prices are declining -- more and more users will install alternate fuel capacity and will turn to imported oil and petroleum products for their base load energy needs. This in turn forces the "captive" natural gas user -- the residential, small commercial and small industrial process and feedstock users -- to face even greater cost increases as the pipelines and distribution companies attempt to recover their fixed costs of operation from a declining customer base. We cannot permit this to happen.

3. Initiatives By Northwest

In an attempt to minimize the decline in sales and precipitous rise in the delivered price of gas to our remaining customers, Northwest has pursued every means of self help available. Both Northwest Central and Northwest Pipeline have exercised "market-out" provisions where possible. Both pipelines are actively seeking to renegotiate existing contracts to provide price reductions, reductions in take-or-pay obligations, and operable "market-out" provisions where none currently exist. While Northwest Central is not presently contracting for the acquisition of new reserves, and Northwest Pipeline's efforts in this regard are at a minimum, any new contracts executed by either pipeline will include "net back" pricing provisions to ensure market responsiveness, broad "market-out" provisions, and flexible "take-or-pay" provisions that minimize take obligations and maximize makeup rights.

On the Northwest Pipeline system, we believe we have control of the situation. Since April, 1982, we have been able to lower gas acquisition costs by over $140 million. The problem in the Pacific Northwest is the high Canadian border price, which is set, not by contract, but by Canadian government action. We are working diligently and aggressively to try to secure lower prices from Canada, and we will continue these efforts.

I must advise the Committee, however, that we have not yet been able to bring the gas price crisis under control on the Northwest Central system which serves the Mid-West. Despite our best, and repeated, efforts, the producers supplying virtually all of the high-cost gas to Northwest Central have been unyielding in their response to our contract renegotiation initiatives. We cannot renegotiate if the producers will not renegotiate.

The Northwest Central contract problem lies in major part with tight-sands gas, the price for which was set by the FERC. When Northwest Central entered these contracts, the applicable price was $1.51/MMBtu. By FERC action, the applicable price today is $5.44/MMBtu, plus severance tax reimbursement. Tight sands gas in Wyoming costs us over $6.80/Mcf at the wellhead. Parenthetically, I would note that these contracts not only appeared acceptable to Northwest Central when entered into, but they were also supported by our customers and State Commissions, and accepted by the FERC itself. The arrangements for acquisition of Northwest Central's Wyoming supplies were presented to and approved by the FERC after a contested hearing.

These contracts should be renegotiated. They are totally unresponsive to the market. But the producers will not yield.

As a consequence, Northwest Central is faced with taking gas at $6.80/Mcf, or paying for gas not taken at $6.80/Mcf. The take-or-pay exposure under these and other Northwest Central contracts is very substantial. Our current projections indicate approximately $125 million in 1983 alone. While we can carry this burden, if we must, it must be emphasized that no pipeline can continue indefinitely to pay for gas it does not presently receive and may never have the ability to make up. Financing these "take-or-pay" obligations coupled with the unconditional loss of the take-or-pay payments if the gas is not made up within the prescribed time period, will not be possible.

We have reached the inescapable conclusion that the problems cannot be resolved without prompt and responsible congressional action. No individual pipeline or collective industry initiative can amend the NGPA or the wellhead gas purchase contracts entered into in reliance on the assumptions inherent in that legislation.

4. The Administration's Legislative Proposal

With this background, I would like to briefly discuss the substantial problems with the Administration's proposed solution to the gas pricing crisis. I have asked Rush Moody, Jr., of the firm of Akin, Gump, Strauss, Hauer and Feld, Washington, D.C., and a former member of the Federal Power Commission, to examine the Administration's proposal to determine its impact on the natural gas industry and the consumers it serves. I have attached his detailed analysis to my testimony. I emphasize two points developed fully in this analysis:

First, the Administration proposal will result in unnecessary price increases.

The current delivered price of natural gas is too high. Yet, the Administration's proposal will result in even higher prices by terminating all wellhead price controls. The elimination of wellhead price controls on "old" flowing gas -- gas produced from wells where all or most of sunk investment has already been recovered -- will increase rates to consumers served by Northwest Pipeline and Northwest Central by billions of dollars. What will consumers receive in return for these higher prices? Nothing, for unlike the NGPA, which provided incentive prices for new drilling, this windfall for the producing industry bears no relationship to new exploration efforts to replenish supplies for our next generation.

Second, the Administration's proposal jeopardizes an adequate and secure supply to those dependent upon natural gas by permitting abrogation of all contracts by natural gas producers on January 1, 1985. From that day forward producers would then be free to shut in their gas wells, withdraw unilaterally from all service obligations, and redirect their natural gas to any purchaser offering better terms than the former purchaser. Distribution companies and direct industrial users, who executed gas purchase contracts with pipeline companies based on the belief that those pipeline companies would secure by contract adequate gas supplies to meet their needs, would face the prospect of substantial, damaging supply interruptions.

As the Committee will appreciate, the problems raised and discussed in Mr. Moody's analysis apply generally across the board in terms of impact upon the industry and the gas consumers of this country. But I am concerned that the Committee understands the specific severe impact the Administration bill will have upon Northwest Pipeline and Northwest Central.

As a starting point, you need to understand our current mix of supplies on each system. At present, the average cost of domestic purchased gas on the Northwest Pipeline system is approximately $2.70/MMBtu, while the average cost of purchased gas on the Northwest Central system is approximately $3.10/MMBtu. Each pipeline has a mix of supply contracts which contribute to the average cost, some contracts calling for lower than average prices, while others specify higher than average prices.

Let us suppose for the moment that the Administration's proposal is enacted. On January 1, 1985 all producers selling into both systems will be free to abrogate their existing contracts if they have not obtained a renegotiated contract acceptable to them, and each of the pipelines can at the same time walk away from any contracts which are not renegotiated to their needs, we must first assess the implications of the withdrawal of supplies upon our ability to render service.

Our preliminary calculations with respect to the Northwest Pipeline system indicate that if we permit all of the low-cost domestic gas to leave the system through producer abrogation, we will have significant curtailment in the remaining winter months of January and February 1985, and in subsequent heating seasons; unless, of course, we replace the withdrawn low-cost domestic gas with additional Canadian import volumes which are currently priced at $4.94/MMBtu.

Our work thus far also shows clearly that if we permit the withdrawal of low-cost domestic gas supplies on the Northwest Central system in January of 1985, we would be thrown into immediate curtailment of service. On this system, almost 65% of the total system reserves are old, low-cost reserves and if these are withdrawn by producer contract abrogation, Northwest Central could not meet its service obligations;

unless, of course, it replaced the low-cost volumes with high-cost gas.

What, then, are these two interstate pipeline companies to do? The Administration would say "renegotiate." And so we will try. But when these pipelines go to their high-cost producers and say "We must renegotiate your prices downward," and when the producers respond "What's in it for me?" the pipeline has no adequate response. It has nothing to offer to the high-cost producer in return for a price reduction, save the threat that if the producer does not renegotiate downward, then the pipeline will abrogate the high-cost contract on January 1, 1985. This threat has no substance, and the high-cost gas producer knows it. He knows that the pipeline is threatened with loss of its low-cost gas and can ill-afford to cancel any contracts if it is to maintain service. And certainly the high-cost producer knows that he can continue to enjoy the benefits of his high-cost contract until January 1, 1985, and then, at worst, re-market his gas on the basis of the then market clearing price. There is simply no reason under this bill for a high-cost gas producer to agree to an immediate downward price revision.

But at the same time that the pipelines are trying -- I believe without any hope of success -- to move some contract prices downward by negotiation, there most assuredly will be low-cost producers demanding upward negotiation in their prices. And in this instance, there will be a very real threat if these upward price demands are not met. The threat, of course, is that the low-cost producer can abrogate his contract and either shut-in his gas or market it elsewhere.

I should point out that when the low-cost producer who has in his hands the ultimate weapon of abandonment of all service obligations comes knocking on the door to insist on higher prices, Northwest Central and Northwest Pipeline face the ultimate "Hobbson's choice." Either they agree to price increases which the market cannot bear, and which, under the Administration's proposal, cannot be passed through without years of litigation, or Northwest Central and Northwest Pipeline will condemn its customers to shortages and interruptions of service.

Please make no mistake about the price consequences of what will be produced by the Hodell proposal. Northwest Pipeline has approximately 2.3 trillion cubic feet of old gas presently connected to its system which is presently priced, on average, at $1.37/Mcf. If Northwest Pipeline is forced to accede to market clearing prices for these supplies, we estimate that the additional revenues generated for the gas producers will be approximately $177 million in 1983 alone, and will be $5 billion over the productive life of the reserves.

On the Northwest Central system the price increases will be even more horrendous. There are approximately 4.1 trillion cubic feet of old gas reserves presently committed and dedicated to the Northwest Central system, which are being purchased at a present average price of $.81/Mcf. If Northwest Central is forced to pay market clearing prices for this gas as the only means of providing reliable and adequate service to its customers, $204 million in additional revenues will be paid to the producers in 1983 alone, and, over the productive life of the old gas reserves, $8.5 billion will be paid.

These additional producer revenues are a pure windfall. If your constituent mail is, as I suspect, currently reflecting gas consumer outrage with present natural gas prices, just prepare yourselves for the deluge which will result if the Administration proposal is passed.

Conclusion

The Administration's proposal is indefensible. It will only exacerbate the present crisis. What is needed is emergency legislation which will provide an immediate cost reduction to residential natural gas consumers, while allowing pipelines to price gas competitively to industrial users. This legislation (1) must provide natural gas pipelines with the legal ability to reduce deliveries of high priced natural gas where necessary to respond to market conditions; (2) must restrict the operation of take-or-pay provisions so that every pipeline has the legal ability to avoid being forced to take or pay for natural gas which is not priced competitively in the marketplace; (3) must provide natural gas producers who require minimum deliveries in order to avoid loss of oil production, protect against drainage or avoid irreparable financial damage, an appropriate mechanism for implementing minimum delivery requirements consistent with the needs of consumers and the realities of the marketplace; (4) must provide producers adversely affected by a purchaser's market related decisions an opportunity to make alternative sales arrangements; and (5) must remove existing demand constraints in the industrial market.

In closing, I again wish to emphasize the severity of the present situation, and the imperative need for expeditious congressional action to alleviate the continuing escalation in natural gas prices and the resulting, but unnecessary, consequences of these increases.

Thank you for the opportunity to appear before the Committee.

Preliminary Analysis of Secretary Hodel's Legislative Initiative to Decontrol Natural Gas

February 28, 1983

Rush Moody, Jr.

Secretary of Energy Hodel has proposed an eighteen point legislative program which is the basis for natural gas decontrol legislation sponsored by the Administration in the current session of Congress.

SUMMARY

1. The Hodel proposal is touted as a balanced, comprehensive solution to all natural gas problems, which is appropriately protective of the gas consumer. Analysis indicates that this is not accurate; the effects of the Hodel proposal will be strongly anti-consumer. Enactment of this decontrol initiative will not only cause natural gas prices to rise, but will result in natural gas producer market control in 1985. This conclusion is based upon these facts:

a. Under the Hodel plan, on January 1, 1985, every natural gas producer may lawfully abrogate every existing old gas sales contract, and thereupon shut in all gas wells covered by those contracts and withhold from consumers the natural gas supplies upon which they depend. Secretary Hodel thus recommends a law which lets the gas producing companies unilaterally abandon their existing gas sales, and then control the flow of natural gas free of old contract or regulatory constraints. After January 1, 1985, natural gas prices will be set by gas producers, for the producers will dominate the market.

b. There are no safeguards built into the Hodel plan which can possibly balance the market control gas producers would acquire on January 1, 1985. The features claimed to be consumer protective -- "capping" natural gas prices until 1/1/86, and restricting interstate pipeline automatic flow-through to consumers of purchased gas cost increases above the rate of inflation until 1/1/86 -- turn out to be window-dressing. Neither provides protection against the January 1, 1985 contract abrogation scheme explicit in the Hodel proposal.

2. The Hodel plan does not address effectively the two problems responsible for today's natural gas price crisis: statutory and contract automatic price escalations, and take-or-pay contracts.

DISCUSSION

The summary conclusions will be discussed separately.

1. Higher Prices Will Result

It is a proven fact that absent Congressional intervention, natural gas prices will continue to escalate, even while surplus deliverability exists, as a result of upward price rigidities built into existing laws and contracts.

The Hodel proposal, contrary to its supporting rhetoric, does not provide a mechanism to break the price spiral, and will instead compound the natural gas price crisis by forcing prices upward when prices are already too high. Upward price pressure is built-in in three separate respects:

- All wellhead price controls end 1/1/86, but non-price federal regulation (which governs gas producer service obligations) terminates on 1/1/85. On that same date, 1/1/85, all contractual limits on wellhead prices in old gas contracts can be abrogated - at the gas producer's option. "Old" gas, at present about 35% of the gas moving in interstate commerce, and which is owned in major part by the major oil companies, thus will either be priced upward when producers abrogate the contracts applying to this gas and re-sell this old gas at higher prices, or the gas will be subject to withdrawal from the market by a producer's unilateral decision, until such time as the producer procures a price acceptable to him.
- Between enactment and 12/31/85, "area rate" clauses in existing contracts can trigger price increases for the gas sold thereunder up to the level of new contract prices agreed to anywhere in the country.

- Between enactment and 1/1/86, natural gas price escalations written into the NGPA and existing contracts, and the cost of presently deregulated natural gas, will continue to drive consumer prices upward. These pressures are not restrained by the Hodel plan unless gas producers and gas buyers set new contract prices at levels low enough to interrupt the operation of escalator and deregulated gas clauses.

2. Reliable Service is Threatened.

As grave as the price consequences of the Hodel plan are, the impact of the proposal on reliable and adequate natural gas service is of equal concern.

There can be only one result of the Hodel proposal that (a) on January 1, 1985 any unmodified natural gas contract may be abrogated, and (b) on that date all gas will be decontrolled from the non-price regulations of the Natural Gas Act and the Natural Gas Policy Act. On January 1, 1985 all natural gas producers in the United States having old gas contracts which they do not choose to honor are free to shut in their gas wells and withdraw, unilaterally, from all service obligations. Gas producers would then be free to redirect their natural gas to any purchaser offering better terms than the existing purchaser, or continue withholding gas from market until their terms of sale are met.

Against this legislative structure, no one can guarantee that the flow of natural gas in the United States to the millions of consumers dependent upon it will continue without interruption, in volumes sufficient to meet essential needs of homes and businesses. As of January 1, 1985 there would be no means by which any gas producer could be compelled to honor his old contracts, nor compelled to fulfill the supply function upon which the public utility service of natural gas transmission and distribution has been constructed. No one would be authorized or empowered to diminish gas producer domination of the gas economy. Natural gas formerly subject to old contracts would move if and when the gas producer chose, and only upon terms and conditions dictated by the producer.

The Hodel contract abrogation proposal will have dramatic adverse consequences for financial institutions as well as for pipelines, distributors, and consumers. If the Congress grants to the producers absolute power on January 1, 1985 to decide which old contracts will be honored and which will be dishonored, the billions of dollars in outstanding pipeline debt must surely be in jeopardy when gas supplies are withdrawn from the market. There is no mechanism in the Hodel proposal for protection of the legitimate interests of lenders who provided the funds to build the pipeline and distribution network in this country. If the failure of the Penn Square Bank caused ripples in financial circles, then surely the enactment of the Hodel proposal will cause tidal waves.

Granting to gas producers a right of abrogation of all existing contracts on January 1, 1985 is wholly incompatible with the nature of the natural gas business as a public utility.

An entire economy has been developed on the fundamental premise that natural gas consumers are entitled to reliable and adequate service at the lowest reasonable cost. Pipelines, distributors, and consumers have entered into long term contracts and commitments in reliance on this structure. If gas supplies can be suddenly and unilaterally withdrawn from the system, the system will fail.

The Hodel proposal -- for whatever reason -- fails to recognize that that natural gas business is the public's business.

3. Consumer Protection Is Not Provided.

Knowing that certain parts of the Hodel plan will push natural gas prices upward, and threaten reliability of service, are there other parts of the proposal which guard against these results?

As to reliability consequences -- the grant of the power to the producer to withdraw and withhold old gas supplies -- the Hodel plan is totally silent. The consumer has no protection; he must depend upon the gas producer not to exercise the lawful powers which he acquires under the Hodel proposal.

As to price consequences, the Hodel plan provides partial, but inadequate, consumer protection through

a. Pipeline purchase review by FERC;

b. Utilization of a price "cap" which is supposed to limit escalations and deregulated gas costs; and

c. Provisions for freedom in re-negotiation of old contracts.

Singly, and in combination, the "consumer protection" given by these three features is only illusory.

a. A Partial Review of Pipeline Purchases Through 1/1/86 Will Not Protect Consumers.

The feature of the Hodel proposal designated by its advocates as explicit protection of consumer interests is a plan whereby, through December 31, 1985, an interstate pipeline may not immediately pass-through purchased gas costs above its last pre-enactment level plus inflation; for this time interval, any additional costs would have to be specifically approved by the FERC after a public proceeding.

The promise of consumer protection is a sham. First, the Hodel proposal operates only on interstate pipelines. Those gas consumers served through intrastate pipelines have no protection. Second, the FERC review promised by the Hodel proposal ends on December 31, 1985 -- at the end of Federal price controls. In 1986 and thereafter, when decontrol is fully effective, the Hodel proposal makes no provision for regulatory review at all, even as to the interstate pipelines. And third, the Hodel plan may serve to delay, but certainly not to deny, increased natural gas rates.

It is clear that the Hodel plan cannot legally be implemented to deny recovery by interstate pipelines of necessary costs, prudently incurred from date of enactment through 12/31/85. In recognition of this, The Hodel proposal does not purport to outlaw rate increases, but only envisions that interstate pipelines will, from enactment to 1/1/86, pay for the purchase of natural gas, and then stand at risk as to whether they recover the dollars actually spent.

While there may be surface appeal in constructing some device to hold interstate pipelines accountable for the prices which they pay, surely there can be no appeal to the Hodel approach when one recalls that an interstate pipeline's purchased gas costs can be expected to increase between now and January 1, 1986 for four separate reasons, only one of which is even remotely within the pipeline's control. Future increases in purchased gas costs will occur:

- under the Hodel Bill, if new contract gas prices carry the price "cap" upward. In this connection it should be borne in mind that the purchasing pipeline whose rates are under review may not have contributed to this price increase because it did not purchase new gas at higher prices;
- if the pipeline honors existing contracts which require rate increases consistent with the statutory escalations written into the NGPA;
- if the pipeline experiences a normal decline in the production rates of old, low cost gas;
- if the pipeline whose rates are under review has paid higher prices itself under new contracts or renegotiated contracts.

Those increases in purchased gas costs which are beyond the control of the pipeline whose rates are under review, and those increases which, although within the pipeline's control, are prudently incurred, must surely, in logic and in law, be permitted after the FERC public hearing process has run its course. And at this point it becomes apparent that consumers will find their gas rates increased, not only to cover legitimate purchased gas cost increases, but also to compensate the pipeline for the working capital which it will have tied up when it made legitimate purchases. Thus the FERC review mechanism proposed by Secretary Hodel will cost the consumer more in the long run. It will delay rate increases, but it will make them larger when they ultimately occur.

Entirely aside from the fact that the FERC review proposal will not protect against rate increases, that proposal should be rejected. First, the Hodel proposal is inequitable. It says, in effect, that if a pipeline and a producer agree to an improvident contract, the gas producer gets to keep the benefit of the improvident bargain by retaining the money that it has received, and the pipeline must stand the entire loss associated with an after-the-payment review by the FERC. This will result, in the case of a contract judged to be unwise, in unjust enrichment of gas producers, and harsh, if not impossible, financial burdens for the interstate pipelines.

Second, the review proposal will produce side-effects not apparent on its face. The Hodel proposal will re-create the dual market which proved so destructive of national interests during the 1970's. Since the Hodel proposal operates only on interstate pipelines, intrastate pipeline buyers, and the industrial buyers who are urged into the gas market by Secretary Hodel will have clear competitive advantages in contracting for new gas supplies. These buyers, who will be free of federal price review strictures, can be expected to become the dominant buyers of new gas supplies during the period in which the Hodel review procedures would be operative.

It must be recalled that the principal impetus for passage of the Natural Gas Policy Act in 1978 was the imperative necessity for eliminating the dual market, and the advantages of the intrastate market in pre-empting new sources of supply. To reintroduce the dual market makes no sense and can only produce profoundly adverse consequences for the natural gas consumers through most of the United States who are dependent upon the interstate pipelines for reliable and adequate supplies of natural gas.

b. The price "cap" mechanism cannot be depended upon to function as a price restraint.

Implicit consumer protection is claimed for the Hodel price "cap". The premise underlying the Hodel proposal is that new and renegotiated contracts for the sale of natural gas will reflect lower prices than have prevailed in the past. Utilizing this premise, new and renegotiated contract prices are to provide a "cap" which would be superimposed on existing contract prices, both as to base price and escalations embodied in the contracts.

If the fundamental premise of the Hodel proposal cannot be sustained -- that is if new contract prices used to determine the "cap" move upward instead of downward -- then clearly the proposal will not result in lower or restrained prices, either for new and renegotiated contracts, or with respect to existing contracts.

To demonstrate that the buyer-seller bargaining process will produce lower prices, the proponents of the Hodel proposal must show that:

- Alternate fuel prices will continue to trend downward;
- all gas buyers and sellers will, through the private negotiation process, react to lower alternate fuel prices with lower gas prices; and
- the process of private negotiation between buyer and seller can be relied upon to be protective of consumer interests.

This burden cannot be discharged. As to the first issue, alternate fuel prices will move upward, or downward, in synchronization with OPEC's strength, or weakness. Building U.S. natural gas pricing policy on the assumption of OPEC weakness may be short-sighted.

If we assume OPEC weakness, however, and declining oil prices, still it is necessary to the working of the Hodel proposal that all buyers and sellers behave in a manner consistent with the downward price movement of alternate fuels. The Hodel price "cap" is built upon the volume-weighted average of the price for natural gas in all contracts.

It is patently unrealistic to suggest that all natural gas buyers, will contract on the bais of heating content alone. The Hodel proposal embodies the concept that users of natural gas should embark upon direct gas buying programs in the field, with the interstate pipelines to provide carriage of the gas so contracted for. The most probable buyers under this scheme will be those large industrial concerns which use natural gas as a feedstock for petrochemicals or fertilizer, and those large industrial concerns which use natural gas in a process application necessary to their manufacturing operation. These buyers do not value natural gas on the basis of heat content, but as a raw material essential to their manufacturing operation. The price which feedstock or process users will be willing to pay is not a function of the price of crude oil or petroleum products, since neither of these will easily substitute for natural gas. Since there can be no assurance that new contracts between buyers such as these and gas producers will reflect the price requirements of the home, small business, or small industrial enterprise dependent upon natural gas, there can be no assurance that the Hodel price "cap" will function as intended.

Utilizing a price "cap" determined by prices paid by gas buyers who utilize natural gas for specific, non-heating purposes, is difficult to defend. Equally indefensible is a "cap" which fails to recognize differences in transportation and distribution costs. A purchaser whose market is close to a source of supply can offer a higher price than a purchaser whose market is far removed. But, under the Hodel proposal, the higher price impacts the purchased gas costs of all pipelines.

If, for example, one interstate pipeline does not need to purchase new supplies of natural gas, and has brought its market into balance on the basis of its own contracts and renegotiation efforts, that pipeline, and the consumers dependent upon it, will nonetheless have price increases visited upon it under the Hodel proposal if buyers and sellers unrelated to that pipeline system reach high contract prices through their own private bargaining. While the higher price may be fully reflective of the respective needs of buyer and seller, why should the higher price in that instance produce higher prices all across the country?

Our third concern with the price "cap" approach should be whether private negotiations can be depended upon to protect the gas consumer. History would indicate cause for concern. We are all too familiar with contracts for natural gas at prices up to and exceeding $10/MMBtu. What is it that has changed that now gives the Administration such confidence that gas buyers and gas sellers will give to the gas consumer the same degree of protection of his interest as the private parties give to the protection of their own interests?

But the Hodel proposal suffers more than the simple defect of naivete in its reliance on private negotiations to protect the public interest. The proposal builds in an incentive for gas producers to force all natural gas prices upward by entering into contracts among themselves at higher prices than should otherwise prevail. One must bear in mind that the major natural gas producers are also major natural gas consumers in their refinery and petrochemical operations. The Hodel proposal will encourage Producer A with a supply of gas close to the refinery of Producer B to enter into a new contract embodying prices which will -- through operation of the Hodel "cap" -- produce greater revenues to both Producer A and Producer B on the gas sales of each. This does not suggest that Producer A and Producer B need to be motivated by bad faith, for their contractual arrangements might logically reflect a higher contract price than could be offered by a pipeline purchaser of the gas because of avoidance of transportation and distribution costs. The fact remains that the Hodel proposal carries within its own structure the potential that the price "cap" will become a device to carry natural gas prices in an upward spiral.

c. Contract negotiation and renegotiation cannot be depended upon to lower or restrain natural gas prices.

One must conclude from the outline of the Hodel proposal that the Secretary of Energy assumes that old gas prices will be renegotiated upward between now and January 1, 1986, in tandem with downward negotiation of prices under high cost contracts, so that on balance the consumer will end up with a market clearing price for all gas in advance of January 1, 1986 and a stable and reliable supply base committed to the renegotiated contracts. But what if the Secretary's expectations are not realized?

The answer, unfortunately is that on January 1, 1985 there will be a massive price shock as gas producers secure high prices for their old gas; and/or that producers will exercise their newly-granted market power to bring the natural gas consumers to their knees.

If the assumption of the Hodel proposal -- that renegotiation will occur and soften the impact of decontrol of old gas -- is incorrect, then the Hodel scheme is hopelessly flawed.

Let us examine, then, whether the potential for renegotiation is real, or only a product of wishful thinking. Successful negotiations require a community of interest between buyer and seller, and roughly equal bargaining strength. If either element is lacking in the natural gas market today, then risking the consumer's well-being on the hope of successful negotiations is fool-hardy.

The Hodel proposal precludes equal bargaining power by its grant to the producers of the right to abrogate all old gas contracts on 1/1/85. All producer incentives to agree to substantive renegotiation prior to January 1, 1985, are removed when the producer is told that he has only to wait until that date and then will be free to walk away from all existing service obligations, shut in his old gas production if the price is not right, and await the inevitable shortage conditions which will result.

The only hope for renegotiating high prices downward which the Hodell plan holds out is the hope that producers and pipelines will agree to negotiate low-price contracts upward. For the consumer, there is no hope.

The premise of renegotiation of both high and low price contracts simultaneously is workable only in those rare instances where a pipeline purchaser has contracts with the same producer for rougly equal volumes of both high and low cost supplies. This is not the demonstrated case on any pipeline system in the United States.

Unless there is a balance of low and high price gas contracts between the same parties on the same system, then the purchasing pipelines are placed in a situation where they will be able to obtain renegotiation upward of the low price contracts (since this would clearly be in the sellers' interest), but are powerless to engage in meaningful negotiations for downward price movement of the high cost contracts. In these contracts what is it that the purchaser can offer as a *quid pro quo* for a price reduction?

With respect to low price gas contracts, why should a seller engage in substantive negotiations in 1983 or 1984 if he knows that his gas will be completely decontrolled in January of 1985? His interests are better served by waiting for decontrol. If however, the seller is willing to renegotiate upward, the interstate pipelines may not safely agree to higher prices -- even though it desperately wants to do so to avoid producer abrogation of the contract on 1/1/85. If the pipeline agrees to pay more, it will be at risk for the increase under the Hodel plan for denial of automatic passthrough of increased costs.

Parenthetically, one should note the hearing record constructed by Chairman Philip Sharp of the Subcommittee on Fossil and Synthetic Fuels, United States House of Representatives Committee on Energy and Commerce in January and February of 1983. The record there developed demonstrates conclusively that although natural gas buyers and sellers have been under strong pressures to renegotiate high cost, high take-or-pay contracts since last fall, no meaningful renegotiation has taken place. With the Hodel promise of decontrol on January 1, 1985, any possible incentive for the producer to engage in meaningful renegotiations has been removed; and with the Hodel threat of denied cost recovery, the pipelines' incentive to renegotiate is destroyed. The prospects for constructive renegotiation -- remote as they have proved to be -- will become nonexistent if the Hodel plan is adopted.

4. The Hodel Proposal is Impossible to Administer.

It is ironic that an Administration purportedly dedicated to getting the government off the back of the people should advance, with apparent seriousness, the Hodel proposal. Let us suppose for a moment that the Hodel proposal is found by Congress to be free of controversy and appropriate for quick enactment so that the Hodel Bill becomes law in mid-1983.

At that point, what will be required of the federal government?

There are 35 major interstate natural gas transmission companies presently operating in the United States. Each of these companies historically has filed purchased gas adjustments semi-annually, and, on average, general rate increases annually. The FERC would, under the Hodel proposal, be required to add to this case load a new species of rate proceeding: one wherein adjudication of each filing reflecting increases in the average cost of purchased gas is attempted. Examination of each pipeline purchase to determine if the pipeline is entitled to reimbursement of costs already incurred must take place.

Even If the FERC can withstand this burden without becoming hopelessly ensnarled in fashioning procedures for, and hearing and deciding a new type of rate case, one can nevertheless predict with near total certainty administrative breakdown in 1985.

Beginning on January 1, 1985, as producers are permitted to abrogate all then existing old contracts, the Commission must be prepared to deal with curtailment cases on those pipelines from which the producers are withholding gas supplies, while simultaneously attempting to deal with the transportation and rate matters envisioned by the Hodel proposals as gas sellers shop their supplies to new buyers.

The Hodel proposal reflects no appreciation of the difficulties of implementing massive shifts in gas supplies away from the usage patterns established under existing contracts.

In those instances where a producer dishonors his existing contract on January 1, 1985 (because he has been given by Congress the right of abrogation) and enters into a sales agreement with a different purchaser, it is ingenuous to say that requiring the old purchaser to transport the gas solves the delivery problem. Moving natural gas from its point of production to its point of consumption normally requires a coordination of facilities and operations among many pipelines and distribution companies. It would be rare indeed if a shift in purchasers could be implemented only through the facilities of the prior purchasing pipeline. But certainly, in early January, 1985 when the large petrochemicals or refineries which have made direct sales contracts with producers demand that the gas be delivered to them and it becomes the job of the FERC to meet these demands, it will be instantly apparent that Congress has created a structure impossible of administration.

5. The Hodel Plan is Not Responsive to Current Problems

The Hodel proposal does not respond to the immediate crisis already confronting the natural gas consumer. The current crisis is one of price. Natural gas prices have escalated, and continue to escalate in a time of falling demand and excess deliverability. Natural gas is presently priced beyond the reach of many residential consumers, and below the cost of alternate fuels to the industrial user of natural gas. The present crisis is one compounded of statutory price escalations built into the NGPA, and wellhead contracts which are not responsive to changing market conditions because of excessive take-or-pay obligations.

The Hodel proposal addresses these root causes of the present crisis only superficially. Escalator clauses would be limited only until 1/1/86, and during this short time frame, the limitation would be effective only if new natural gas contract prices are lower, on average, than existing escalator clauses would dictate. Thus the Hodel proposal will allow all contract escalators to become fully effective again in January of 1986, without regard to consumer impact at that time. Prior to January 1986 Secretary Hodel would permit the escalators to operate up to the level set by gas buyers and sellers as they agree to new contract prices. There is a total absence of consumer protection in this scheme.

With regard to take-or-pay, the Hodel proposals provide that take-or-pay obligations can be limited to 70% of deliverability, at the purchasing pipeline's option prior to 1/1/86, but if a purchaser takes advantage of this option, then the gas producer is free to sell that portion of his gas not taken at a decontrolled price to another purchaser. Consumer interests are grossly subverted under this scheme. A 70% level affords no meaningful protection against high-cost, high take-or-pay contracts since market conditions, and the price requirements of consumers, presently require reductions in takes far below the 70% level, and this situation will prevail for the foreseeable future. And, if a pipeline attempts to protect its customers by invoking the meager relief offered by the 70% option, the pipeline thereby exposes its customers to the penalty effect of the producer's withdrawal of reserves dedicated to the contract and marketing of those reserves elsewhere.

In summary, the Hodel proposals will exacerbate, not solve, the existing price crisis. Neither price escalation nor take-or-pay problems have been solved.

CONCLUSIONS

The Hodel proposal does not meet the existing problems of price escalation and take-or-pay contracts. The Hodel proposal guarantees higher prices, unreliable service, and an administrative breakdown.

There are only illusions of consumer protection in the Hodel proposal. In reality, the proposal, if adopted, grants to natural gas producers sole and absolute control over the natural gas industry.

The Hodel proposal permits contract abrogation by gas producers of all existing natural gas contracts on January 1, 1985 and thus plants the seeds for economic collapse of natural gas pipelines, distribution companies, and the financial institutions which have advanced funds to them.

The Hodel proposal cannot be fairly characterized as merely ill-advised; it will, if enacted, make it impossible for the gas consumer to receive reliable and adequate service at the lowest reasonable cost.

Senator MURKOWSKI. Thank you, Mr. McMillian. We will proceed on with Mr. David Wilson, president of the Coalition for Equal Access.

Mr. Wilson, we welcome you to the committee and ask that you proceed.

STATEMENT OF DAVID W. WILSON, PRESIDENT, ASSOCIATION FOR EQUAL ACCESS TO NATURAL GAS MARKETS AND SUPPLIES

Mr. WILSON. Thank you, Mr. Chairman. I am David Wilson, president of Natural Gas Equal Access, a group of independent producers that are basically dedicated to creating a national market for natural gas.

Our association has many individual members and our efforts have been supported by several major trade associations, having over 8,000 members.

We feel very strongly in Natural Gas Equal Access that gas should be able to be marketed like all other commodities, and that is by direct negotiation between producers and users or their wholesalers.

The current gas market is very regional in nature, with end user prices varying between $3.50 and $9 per thousand cubic feet on a delivered basis.

Right now—and this inefficiency will continue well into the future, but right now drilling decisions in the oil patch are being made not on geology, the way they should be, but based on who the particular pipeline purchaser is in the area and what their purchasing practices are.

The markets are basically controlled by the pipelines who have monopsony power over the producers of gas in their area and have monopoly power over the users of gas on their system.

These powers in the past have been abused and this must not be allowed to continue in the future. The administration bill has the avowed purpose of working toward a national market for natural gas by allowing direct sales between producers and users.

For that, we feel that the administration is to be congratulated in moving in that direction. However, there are several important omissions from their bill that we feel will frustrate their goals being achieved.

There are some very essential elements to achieving a national market that we would like to discuss and how the administration bill either addresses them or does not address them.

Producers must be able to make direct sales to all kinds of purchasers anywhere in the country. The administration bill is OK, except for some transportation problems, some user obligation problems, and also some dealings that will be made possible under the administration bill, some dealings between pipelines and their production affiliates.

For example, during the interim period between day of enactment and January 1, 1985, there will be no renegotiation of contracts without pipeline approval.

You only have to look at the pipeline dealings with their affiliates in section 107 gas to realize that there is a problem in that bill.

Under the administration proposal, pipelines can renegotiate early, ahead of independent producers with their affiliates for old gas sales contracts.

Once those contracts are renegotiated, then pipeline affiliates will be able to sell their gas either to the pipeline affiliate or system supplies or to the direct sale market which has been opened up under the administration proposal.

This flexibility with the affiliates will work to the detriment of both local distribution companies and unaffiliated producers on the system who may not get their chance to renegotiate until very well late in the game.

Come January 1, 1985, when many producers can and probably will get marketed out, they may find that the direct sale market has been partially filled by pipeline affiliates' gas.

Ironically, a lot of the affiliates' gas that will be renegotiated or can be renegotiated during this interim period is gas that was previously classified as cost of service gas, gas which belonged to the consumers and the investment was guaranteed by the consumers.

NGEA feels very strongly that pipeline affiliates' gas should not be eligible for direct sales to industrial or to local distribution companies, but that gas should be retained as system gas.

We also feel that these pipelines should not be allowed to discriminate in favor of their affiliates in the renegotiation process during this interim period.

Our second point toward a national market is that buyers must have the option of buying gas directly from producers.

This cannot add to a price spike since they would only buy gas directly from producers if it could be bought and delivered to them at a lower price than what they are paying their current supplier.

The administration bill does not remove a major obstacle to allow purchasers the freedom to buy gas directly from producers, and I am talking about the minimum bill obligations that now exist to these current suppliers.

We feel that as direct gas is sold by producers to local distribution companies and industrial end users, that minimum bill and service obligations both must go down to reflect those direct sales.

Three, for access to work, a sufficient supply of freed-up gas must be available. The administration bill is OK after January 1, 1985, but there may be a problem before that.

For that period a producer could still get marketed out, for example, under an existing contract, but not have the advantage of mandatory transportation under the bill because that only applies to contracts marketed out after January 1, 1985.

Fourth, to have a national market, purchasers anywhere in the country must be able to buy gas from also anywhere in the country.

Here the administration bill falls extremely short. The contract carrier provisions only apply to interstate pipelines.

We feel that the intrastate pipeline system, as well as the local distribution companies, must be covered in order to create a truly national market.

For example, one of the things that we as producers can see happening that would frustrate producers being able to sell gas directly to end users is that interstate pipelines could form intrastate affiliates in order to buy gas in newly developing areas.

And with the administration's bill removing all FERC controls over sales between intrastate and interstate affiliates, thereby the interstate pipelines would be able to effectively deny access to their interstate system by using an intrastate line to do the purchasing in that area.

We also feel that it is inequitable for intrastates to be able to transport gas from outside their State through the interstate pipeline system from anywhere in the country or the off-shore area, while interstate pipelines are not able to do the opposite and get transportation through the intrastate pipelines.

Also, there is a problem in that any new gas found on what is now an intrastate pipeline would not be able to participate in a national market if the administration's bill or contract carriage does not cover the intrastate pipelines.

Our fifth and last major point is that for direct sales to be able to occur transportation obligations must be firm and mandatory.

Without this, pipelines will be able to maintain the monopoly control they have on the market today and the gas market will remain regional in nature.

Here the administration bill also falls short. Under the administration bill, the producer has mandatory transportation only on the pipeline system on which he was marketed out.

His markets, though, may be two or three pipeline systems away. He may have to obtain or try to obtain transportation on more than just the pipeline system that marketed him out and get transportation on one or two other pipelines in order to get to his market.

The administration's bill is not firm and not firm enough, let's say, in that subsequent transportation.

Also, any newly drilled gas that has not been marketed out would have to rely on the contract carriage provisions of the administration's bill, which we don't feel are strong enough.

We feel that all pipelines, interstate, intrastate, and local distribution companies should be required to transport gas subject only to availability of capacity based on actual delivery experience with the burden of proof of nonavailability of capacity being on the pipeline denying transportation.

Further, when the Commission finds a lack of capacity, the pipelines should be limited in their ability to increase throughput of pipeline on gas and also that producers or purchasers who are denied access because of lack of capacity should have first call on that capacity when it is available.

In summary, we support the access concepts in the bill but offer our concepts which we feel are vital for a national market in natural gas to be developed.

Thank you.

[The prepared statement of Mr. Wilson follows:]

Written Statement by David W. Wilson

President, Association for Equal Access
to Natural Gas Markets and Supplies

submitted to the

COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

I. INTRODUCTION

Mr. Chairman and members of the subcommittee, my name is David W. Wilson, and I am Vice President of Corporate Development and Exploration for Consolidated Oil and Gas Company, an independent oil and gas producing company headquartered in Denver, Colorado. I am submitting this testimony today in my capacity as President of the Association for Equal Access to Natural Gas Markets and Supplies. We refer to the organization simply as "NGEA", which stands for Natural Gas Equal Access. For the remainder of this testimony I will refer to our organization as NGEA.

NGEA is a nonprofit association for independent producers and users of natural gas which was established to promote greater access to natural gas markets for producers and greater access to natural gas supplies for users. At the present time, existing laws and regulations limit access to natural gas markets. Producers can sell their gas to any one they please, but only one kind of purchaser can be assured of transporting any gas sold -- a natural gas pipeline to which the producer can be connected. Access to natural gas supplies by distribution companies and end-users is also limited by existing laws and regulations because anyone wishing to buy gas must buy it from only one kind of seller -- again, a natural gas pipeline serving those purchasers. As a result, natural gas is the only significant commodity in our economy that is routinely sold to the shipper at the place of production and subsequently bought from the shipper at the point of distribution or consumption. This works to the detriment of both consumers and producers, as the entire country now knows and which I shall describe in some detail.

First, let me say that NGEA appreciates this opportunity to present its views on natural gas legislation, some of which finally recognizes the many severe problems which now exist in the marketing of natural gas. Our intention is to inform the members of the committee and staff that producers and users are experiencing access problems in the market place which greatly aggravate the inherent marketing deficiencies in the current transportation and distribution system. It is NGEA's overall objective to provide all producers, purchasers, and consumers of natural gas with access to gas markets and supplies equal to the access now enjoyed only by natural gas pipelines. I will describe NGEA's perception of how we came to be in the marketing mess that now exists, present our views on what it would take to get out of that mess and, finally, discuss the Administration's proposal as it relates to the problems we see and the solutions we think necessary.

The system for the movement of natural gas from producers to consumers has been flawed for many decades, but the inefficiencies and inequities of the regulatory structure have become even more severe since passage of the Natural Gas Policy Act (NGPA) and much more obvious in the last several months. The NGPA was primarily oriented toward wellhead price deregulation and its incentive price structure initiated a scramble for new gas as drilling activity was stepped up measurably in response to those higher prices. Pipeline purchasers began scurrying to pick up new capacity and system reserves and, the "cushion" of old gas in the market enabled interstate pipelines to bid the price for Section 107 gas above market clearing levels. Many perceived at the time that the market would remain strong, despite the existence of several factors tending to adversely affect gas markets, including competition with alternative fuels, energy conservation due to higher prices and recent reductions in crude oil prices. Purchasers of natural gas, therefore, proceeded to buy higher-cost gas on a preferential basis. At the same time, federal laws and regulations encouraged pipeline purchasers to aggressively pursue their own exploration and production investments on a preferred basis with regard to both prices and produced volumes.

Many of those who have previously testified before this committee have indicated that the delivered price of gas now meets or exceeds its market clearing level in many areas and is continuing to escalate at an alarming rate. Many others have also correctly testified that the combination of a weak economy and fierce competition from other fuels has caused a loss of industrial demand. Yet, even with these forces at work, which have resulted in excess gas supply, gas prices to end-users continue to escalate rapidly. The main reason for the escalation is that the mix of gas being purchased by pipelines has been increasingly skewed to higher-cost sources. As these practices led to even higher prices, more load has been lost and a vicious cycle is in the making. As the load has been lost, the lower priced conventional gas purchases have been curtailed. This further increased the percentage of high-cost and imported gas in the mix, which in turn caused further load loss and further reductions of takes of conventional lower-priced gas. Producers of conventional lower-priced gas are tied to the system because they have no control over volumes of gas purchased due to the inflexible, regulated system of dedications. Such producers are, therefore, providing free storage to pipelines in many cases. By virtue of these practices, pipeline purchasers are extending the production period of low-priced gas and are thereby also extending the subsidization of high-cost and imported gas through the continued and carefully orchestrated and controlled purchase of low-cost gas over a drawn out period of time. NGEA believes that this deliberate plan on the part of the pipeline goes a long way to explain their opposition to decontrol.

A few specific examples are enlightening. The major pipeline supplier of natural gas to many parts of California purchases gas from the San Juan Basin of New Mexico, and the deep Anadarko Basin, as well as from other areas. As this pipeline increased purchases of deep decontrolled gas from the Anadarko Basin at prices of over $9 per mcf, market resistance began to appear in California. The pipeline began to curtail purchases of gas in the San Juan Basin, where gas is priced under $2.75, to absorb the reduced gas sales to end-users and distribution companies. The preference to take the higher priced gas is, in NGEA's opinion, explained mainly by the fact that pipeline's production affiliate owns a substantial portion of the deep decontrolled gas that was purchased in preference to the lower-priced gas available in the San Juan Basin.

Another typical situation is occurring in the industrial areas of the Midwest and Northeast. Pipeline purchasers have significantly reduced takes of gas in Ohio, Pennsylvania and the Appalachian area at average prices of about $3, while increasing imports and deep decontrolled purchases from the Southwest. Again, a significant portion of the decontrolled gas is from production affiliates of the transmission companies. At the same time, those pipelines have refused to transport gas for producers and users who have attempted direct sales of gas.

A further example is demonstrated in numerous areas of the western United States. Many producers in this area, for example, west slope Colorado and the Sacramento basin of northern California, have seen their takes reduced by half as higher-priced Canadian gas is taken on a preferential basis.

Some may feel that these problems can be solved by "tinkering", legislatively and administratively. NGEA believes that the only viable long-term solution is to put the purchasing decisions where they belong -- in the hands of the end-user or at least closer to the end-user. Through direct negotiations and transactions with producers, distribution companies and end-users would replace the recent purchasing and marketing practices that are now causing so much of the problems of the natural gas industry.

To make this new marketing system work, purchasers at a distance must have the ability to get the gas shipped to them (just as purchasers of all other commodities have that ability). A truly national market for gas would evolve if such direct sales could be made and transportation required. It is NGEA's contention that the benefits of natural gas production can be fairly distributed among the various components of the natural gas industry (rather than being concentrated in the transmission sector) only by developing an effective national market for natural gas. We feel that this will become even more critical as a higher percentage of natural gas becomes deregulated, whether deregulation is accomplished by the timetable established by the Natural Gas Policy Act of 1978 (NGPA) or by intervening legislation accelerating decontrol, such as that proposed by the Reagan Administration.

At this point, I think it would be instructive to review briefly the NGPA and regulations thereunder so that the current access problems can be understood in the context of the existing statutory and regulatory structure.

II. THE NATURAL GAS POLICY ACT OF 1978

After forty years of regulation of the natural gas industry under the Natural Gas Act (NGA) and after many unsuccessful attempts to modify that law, the Congress finally succeeded in passing new natural gas legislation in 1978, the NGPA, as it is commonly referred to. The NGPA did not significantly alter the rate regulation structure of the NGA, but it did bring intrastate gas under the same price controls it imposed on interstate gas and established a seven year phase-out period for wellhead price controls on specified categories of intrastate and interstate natural gas.

The NGPA did not provide any greater access to producers and users of natural gas than had existed under the NGA. It did, however, reduce the competitive advantage previously enjoyed by intrastate systems, since intrastates could no longer pay higher prices than interstate pipelines for new supplies. In fact, the NGPA has caused such a severe imbalance of supply in favor of interstate systems that it has created critical shortages in some intrastate systems. Others testifying before this committee have addressed or will address the problems now being encountered by intrastate pipelines and their customers due to the built-in bias of the NGPA, which has caused a diversion of most new gas supplies to interstate pipelines.

One significant change brought about by the NGPA -- a change that is becoming more critical every day -- relates to the pricing procedure pipelines use to pay for gas produced by an affiliate of the pipeline, so-called affiliate production. Under the Natural Gas Act, pipelines primarily utilized the cost of service method, under which costs of production were used as the price to be paid and were factored into the pipelines' overall operational costs for calculation of rate of return. Under the NGA and until passage of the NGPA, unrealistically low wellhead price controls kept price discrepancies in favor of production affiliates relatively low and insignificant. It is interesting to note that due to a relatively recent decision by the Court of Appeals of the Fifth Circuit, production affiliates are now able to receive higher NGPA ceiling prices, which are being passed along to consumers, for gas that has already been paid for by consumers in previous cost of service charges. Thus, in many cases pipelines will be allowed to pay their own affiliates higher prices than producers receive for gas of the same vintage, even though producers took the risks of exploration, development, and production and pipelines shifted those risks to consumers.

Under current regulations, all a pipeline has to do to justify the price paid to its affiliate in a particular sale is show that it did not pay its affiliates more than the highest amount paid in comparable transactions with unaffiliated sellers. Pipelines have been free to pass on to consumers the gas purchase costs for such purchases from affiliates, unless the pipeline is guilty of "fraud, abuse or other similar grounds." This is a standard that the Federal Energy Regulatory Commission (FERC) has until recently interpreted very narrowly, meaning that almost any price a pipeline pays an affiliate for gas is legal and can be passed on to consumers, even though pipelines may give preferential treatment to production affiliates with respect to non-price elements such as the amount of gas the pipeline is obligated to take.

Many producers are being paid prices below established NGPA ceilings, while production affiliates are receiving ceiling prices for each category, because FERC allows the production affiliate to be paid the highest price being paid to any unaffiliated seller. Producers have and are continuing to enter into contracts without a clear idea of the competitive market for their production. This occurs because of fear of antitrust implications of exchanging information. I am not offering any comment as to whether there are antitrust implications in exchanging price information, but we think it is very pertinent to note that due to FERC protection, pipelines and their affiliates are able to have access to all contracts on their system, and then able to use the most beneficial features of each contract. NGEA feels that the acceptance by FERC of these practices allows the same kind of abuses to occur in gas that occurred early in the history of crude oil pipelines, before the trusts were busted and oil pipelines were forced to be classified as common cariers.

At the present time, the NGA and the NGPA combine to create a regulatory structure which effectively limits access to markets and supplies to pipelines while permitting pipelines to treat their own production affiliates preferentially. Because of this combination, we have seen increases in gas prices consumers and distribution companies must pay pipelines -- increases which were due to higher prices paid for deregulated gas owned or produced by a pipeline's production affiliate. Several of the Purchase Gas Adjustment proceedings of major pipelines have been and are now being challenged by consumers, distribution companies and State utility regulatory agencies on the ground that prices paid for deregulated gas are too high and too much of the increased cost is going to the pipeline's production affiliate. Any modification of gas pricing laws should require that production affiliates be paid no more than the lowest price being paid to any independent producer for each category of gas. Classification of pipelines as common carriers would solve this market-ordering problem as explained later.

III. INEQUITIES DUE TO LACK OF ACCESS CAN ONLY INCREASE IN THE FUTURE

The NGPA's decontrol schedule does nothing to change the major regulatory deficiencies just described. Pipelines are not required to transport gas owned by others, and pipelines will continue to be able to give preferential treatment to their production affiliates.

Distribution companies will continue being unable to develop and produce their own system supplies, even though the pipelines supplying them will be free to do so. Distribution companies will not be able to receive gas produced either by joint ventures with producers or by direct purchases from producers. Distribution companies will be stuck with the purchasing policies and practices that are so often contrary to the best interests of the distributor and the ultimate consumer.

Customers served by distribution companies will continue to be adversely affected by the lack of access of distribution companies. Regional gas cost disparities will only increase under the current pipeline-dominated system, as industrial users react by moving to other locations or switching to other fuels. It should be obvious to anyone that it is cheaper to remove the barriers to gas shipment rather than moving industries and shipping manufactured products. The plight of the fertilizer industry with respect to gas supplies demonstrates the folly that has often been the result of the current natural gas infrastructure.

In addition, as gas prices increase through phased decontrol under the NGPA or otherwise, the existing form of pipeline regulation will not ensure that gas consumers receive the benefit of low prices paid to independent producers. Everyone acknowledges that there is a delivered price above which natural gas is not competitive with alternate fuels, and as long as pipelines kept the delivered price below the alternative fuel price, users did generally not switch to alternative fuels. Pipelines can keep the delivered price below the alternative fuel price by paying the same price or similar prices to all producers, by paying more to some than to others, or by taking more gas from some than from others. As previously mentioned, that kind of pricing and volume preference is already happening with respect to deregulated gas produced from depths greater than 15,000 feet and with other incentive-priced gas. It is a trend that can only become more pervasive as interstate pipelines continue to increase their involvement in gas exploration, development and production.

What is occurring in the market place today defies rational economics. The record is replete with situations where non-incentive gas, which is priced much lower than incentive gas, is not being taken or is being taken in only minimal quantities. This situation exists in every producing area, including California, the Rockies, the Gulf Coast, the upper Midwest and the East. This is occurring because of the pipelines' strong vested interest in high cost gas, e.g., deep, decontrolled gas, incentive-priced gas, Canadian imports and LNG. As previously discussed, under existing law, pipelines need only be concerned with keeping the final mixed gas price low enough to stay competitive with other fuels. They have the freedom to maximize their own corporate profits at the expense of both consumers and producers. It is unthinkable that there are no federal laws or regulations to prevent these inequities.

If a national market existed for gas, and distribution companies and end-users were allowed to negotiate directly with producers, high cost gas would be sold only to those users willing to pay the price. If a market did not exist for high cost gas, its price would drop until it could find a market. Although we are not advocating common carrier status at this time, it would be a better market-ordering device than any incremental pricing scheme that can be devised and administered.

Under the present system, direct-end users of natural gas will have the same problems they have today in obtaining secure sources of supply and encountering the adverse effects of incremental pricing. One likely result is that end-users will end up paying a delivered price for gas that will be substantially higher than the price independent producers are receiving from pipelines and higher than the price the user could have had to pay in direct purchases from producers.

Independent producers will also be afforded very little protection by the NGPA requirement that amounts paid by interstate pipelines to its production affiliate may not exceed "the amount paid in comparable first sales between persons not affiliated with such interstate pipeline." As stated earlier, this requirement appears satisfy current regulatory requirements if the pipeline pays its production affiliate a price no higher than it pays any nonaffiliated producer. Gas purchase negotiations are notoriously complex and resultant contracts are very difficult to analyze and compare with respect to indirect preferential treatment of one producer over another. This is particularly true when the NGPA requirement applies to only one of many important contract elements -- the price. There is no requirement that the pipeline take even one cubic foot of gas offered for sale by an independent producer or that the pipeline take any specified percentage of the gas it commits to buy at a stated price. It is well known within the industry that the best way to get the most favored gas contract is to take the pipeline's production affiliate as a partner.

Under these circumstances, independent producers will be faced with take-it-or-leave-it offers which might comply technically with NGPA requirements but do not provide equitable contract terms for the producer's gas. The incentive for this discrimination is obvious -- the pipeline can take a higher portion of gas from its own production affiliate, using independent production as its "swing supply". That is, the pipeline can satisfy periods of highest demand on the system at the expense of independent producers. As long as the delivered price does not reach or exceed the alternative fuel price, pipelines will encounter no obstacles, regulatory or economic, in maximizing the profits of their production affiliates in the manner just described. Achieving maximum profits for a business is a legitimate and desirable objective, but when it is done through the use of monopoly power at both ends of the pipeline, it is totally contrary to all notions of fair play and protection of the public interest. This allows a regulated entity, an interstate pipeline, to convert the very regulations intended to protect the public interest to a means to increase the profits of its production affiliate.

IV. REMEDIAL ACTION: EQUAL ACCESS TO ALL GAS SUPPLIES LEADING TO A NATIONAL MARKET

The deficiencies and abuses described above are so complex and interrelated that no system of regulation could be devised that would totally eliminate them and even if it could be devised, it could not begin to be administered effectively. As with most such attempts at system-wide regulations and enforcement, the cure is often worse than the problem and usually turns out to be ineffective after all. There is no need for the imposition of another comprehensive regulatory scheme and enforcement program in the gas industry. The solution lies in less regulation, not more, by amending applicable statutes to give all potential purchasers access to all gas supplies anywhere in the country and requiring pipelines to transport gas owned by others at a just and reasonable price. This system could not be imposed on the pipelines overnight, but would have to be phased-in to accommodate existing service obligations.

A specific kind of gas should be identified, which would be a relatively small amount at first, but increase over time, which would be available for sale by producers to any purchaser, with interconnecting pipelines, intrastate or interstate, being required to transport the gas. These categories of gas would include:

-- all new gas produced or contracted for after a certain date, such as January 1, 1983;

-- all gas at the end of its primary contract term or at any contractually agreed renegotiation date;

-- all gas released by exercised of market-out or similar clauses;

-- all gas as to which the purchaser tries to force a unilateral reduction in price without producer approval and has breached the contract; and

-- all gas as to which the purchaser tries to enforce any marketing or pricing modifications to existing contracts which are made possible by legislative or administrative acts.

Pipelines would be allowed to continue to purchase all kinds of gas, including the categories of gas described above, but once bought by another purchaser, such as another pipeline, a distribution company, or an end-user, interconnecting pipelines would be required to transport that gas. The regulations that presently discourage transportation of non-pipeline owned gas would have to be modified to allow the pipeline to receive a just and reasonable tariff for that transportation service. These tariffs could be established in the same manner as the transportation tariff for other common carriers such as crude oil pipelines, railroads, etc. To the extent pipelines are required to transport gas for others, existing service obligations should be correspondingly reduced.

Pipelines subject to these mandatory transportation provisions would exclude unaffiliated gathering systems which would be defined as facilities that are field operations only and do not purchase gas for resale, do not use rights of eminent domain or condemnation in building and which are not owned by a pipeline or distribution company.

This limited form of common carrier status or contract carriage can work since it would produce a national market for natural gas just as common carrier status for crude oil pipelines has achieved a national market for crude oil. It would impose far fewer regulatory restraints and requirements than any other effective change in the present pipeline regulatory structure and would result in maximum utilization of this country's natural gas resource in a manner that would spread the benefits of gas production fairly throughout the system without unfairly burdening any element of the system. It would benefit consumers since their local distribution companies would have more control over their gas acquisition costs.

V. ACCESS FEATURES OF THE ADMINISTRATION'S LEGISLATION

By its development and presentation for congressional consideration of the "National Gas Consumer Regulatory Reform Amendments of 1983," the Reagan Administration has undertaken to broaden significantly access for producers and consumers to natural gas transportation facilities. The Administration, and particularly President Reagan and Secretary Hodel, are to be commended for having taken the first significant steps toward deregulation of the natural gas industry, steps which could eventually lead to a free market for natural gas. When NGEA speaks of a "free market", it includes factors and issues well beyond the matter of wellhead price controls. A truly free market means to NGEA that producers and purchasers of natural gas across the country would be free to negotiate and execute direct sales transactions with the assurance that transportation facilities connecting sellers and purchasers will be available to transport such direct sale gas. Only when that situation exists will there be an effective national market for natural gas in which the benefits of this extremely desirable fuel can be spread equitably throughout the nation.

Essentially, an effective natural market requires at least the following:

1. Producers with gas to sell free from statutory and regulatory restrictions and protected from pipeline monopsony power and preferential self-dealing;

2. Complete access to established and future transportation and distribution systems in which transportation is mandatory, subject to reasonable and accurate capacity limitations and minimum tender requirements; and

3. Purchasers free to buy gas from producers without unreasonable statutory or regulatory restraints and protected from pipeline monopoly power.

Compared against these essential elements required to create a workable national market for natural gas, the Administration's legislative proposal, despite its good intentions and ground-breaking effort, comes up short.

That proposal provides in Section 202 for the elimination of Natural Gas Act jurisdiction over first sales of natural gas, some sales immediately and the remainder as contracts are terminated. This is apparently the section by which the legislation would implement Point No. 9 of the preliminary explanatory material (the Point Paper) stating that "[a]ll buyers have equal access to offshore and interstate gas."

It appears that this provision would be effective to provide such access so that buyers other than interstate pipelines could buy uncontracted OCS gas and previously dedicated interstate gas, both onshore and offshore, as contracts are terminated. That would make a substantial volume gas available for direct sales, at least after January 1, 1985, but does it go far enough?

NGEA is of the opinion that it does not, but I will discuss in detail the importance of the total amount of natural gas made available for direct sales later in this presentation.

As to the gas made available for direct sales by Section 202, what transportation requirements would the proposal impose on pipelines connecting producers and potential purchasers? Evidently, none beyond the requirements set forth in Section 403 entitled "Contract Carrier Authorization". Those requirements are simply not sufficient to be effective in many situations.

The Section-by-Section Analysis states that "[t]his section is intended to open the natural gas market to the operation of the laws of supply and demand to the fullest extent possible by allowing producers and users of natural gas to deal directly with one another." That is a very desirable objective, but since this provision applies only to interstate pipelines, it leaves out entirely those producers and those users served by intrastate pipelines. It also leaves out entirely those users served by local distribution companies, even if the pipeline supplying a particular distribution company is an interstate pipeline. For those reasons and others, this provision will fail to achieve its objective.

In order to achieve that objective, this provision should be amended to require both interstate and intrastate pipelines, as well as distribution companies served by both kinds of pipelines, to transport direct sale gas, subject only to reasonable minimum tender requirements, actual available pipeline capacity and protection of existing pipeline customers. Unless the statutory requirement of mandatory transportation is expanded beyond interstate pipelines, direct sales will be limited to sellers and buyers served by the same interstate pipeline.

While it is true that intrastate pipelines connected to an interstate pipeline from the OCS could buy OCS gas and force the interstate pipeline to transport that gas, there is no reciprocal mandatory transportation requirement imposed on intrastate pipelines for the benefit of interstate pipelines (or any other purchaser, for that matter). Section 401 expands the FERC's power to authorize the FERC to sanction certain transactions between interstate pipelines and intrastate pipelines, but this provision does not impose mandatory transportation obligations on intrastate pipelines.

One result of this one-way access would be that producers trying to sell to an intrastate pipeline could not get a contract from that pipeline at the very same time that pipeline is forcing an interstate pipeline to transport offshore gas made available by this legislation. The transporting interstate pipeline would not even be able to buy gas from the producer in this example, because the interstate pipeline could not be forced to transport that gas.

Another problem that could (and undoubtedly will) arise from the failure to extend Section 403 to intrastate pipelines, would be the creation of intrastate pipeline affiliates by interstate pipelines to insulate such pipelines from transportation of direct sale gas. For example, an interstate pipeline intending to serve a newly emerging gas field could simply structure the part of its system that would serve that field as an intrastate pipeline. Utilizing the liberalizing provisions of Section 401 to deal with its intrastate pipeline affiliate, the interstate pipeline parent could buy all the gas it wanted from that field while preventing the use of any of its system to transport direct sale gas produced in that field. There is nothing in the legislation that would prevent existing interstate segments from being restructured as intrastate pipelines and thereby circumvent the intention and effect Section 403, especially in view of Section 401. Certainly, this result is not intended by this legislation.

To summarize the comparison thus far, NGEA feels very strongly that intrastate pipelines and all distribution companies must be required to transport direct sale gas. Otherwise, a truly national market for natural gas will not be realized and current marketing deficiencies will be perpetuated. Accordingly, NGEA respectfully urges this Committee to amend the Administration's proposal to extend the requirements of Section 403 to all pipelines and to all distribution companies.

Section 302 would repeal NGPA Section 315 and substitute a new NGPA Section 315 to allow current purchasers to refuse to take in excess of 70% of a well's deliverability. As to the exercise of that authority by the purchaser, the producer could "terminate the contract with respect to the volumes refused." It could be difficult, in many instances, to sell only that "volume refused", since it could be any percentage of deliverability from 1% to 30% and even that amount could fluctuate with current purchaser's supply requirements. The correction for these problems is obvious and simple -- allow the producer to terminate the entire contract and allow the entire contract volume be sold to another purchaser.

This provision apparently would be applicable to intrastate pipelines as well as interstate pipelines, but, in any specific situation, Section 303 provides in relevant part that only the "pipeline that was a party to the terminated contract shall have an obligation to transport gas for a producer that was a party to the terminated contract." So while a producer could force an intrastate or interstate pipeline to transport that volume of gas not taken, the only purchasers the producer could sell to would be purchasers physically connected by the pipeline exercising this statutory default authority. Accordingly, the proposal falls far short of providing effective access for such producers as to potential purchasers on other pipelines. Also, the proposal fails to reach even those potential purchasers served by the defaulting pipeline, who are served by a local distribution company between the pipeline and the user.

The remedy is the same as previously stated -- impose on all pipelines and on all distribution companies mandatory transportation of direct purchase gas.

Section 303 of the legislation would create what is called the "Transportation Obligation" which is applicable both to gas released under the provision just discussed as well as by what is called the "Market-Out Provision", new NGPA Section 316. The so-called Market-Out Provision permits either party to a contract for the first sale of natural gas in effect on the date of enactment to terminate the contract during a one-year period beginning January 1, 1985. In the event either party elects to terminate such a contract, the pipeline must transport the gas involved, subject to volume limitations related to past transportation of such gas, available throughput capacity and service obligations to existing pipeline resale customers.

This provision, since it is the very same provision discussed with respect to the take-or-pay provision, is simply inadequate for the same reasons. Its mandatory transportation requirement extends only to the one pipeline that previously bought the gas, thereby limiting the producer to purchasers served directly by the same pipeline. As such, it does not create a national market for such gas.

While it is obvious that many potential purchasers could never participate in direct sales for the reasons already presented, even more potential purchasers are eliminated because of "minimum bill" obligations owed to current pipeline suppliers. While the legislation is careful to limit the mandatory transportation of direct sale gas to protect existing resale customers, it does nothing to reduce or eliminate either minimum bill requirements owed to pipelines or service obligations owed by pipelines by distribution companies. These downstream impediments will cause potential purchasers to be unable to participate in direct sales and will cause pipelines to resist the transportation of direct sale gas.

While the relationships and regulations which create these problems are complex and confusing, the solution is neither. The legislation should be amended to provide that to the extent any purchaser in a direct sale has the benefit of a service obligation or the burden of a minimum bill, both will be reduced by the amount of any direct purchase made by that purchaser, regardless of the identity of the pipelines involved.

VI. CONCLUSION

Mr. Chairman, NGEA greatly appreciates the opportunity to participate in these important hearings. We are grateful to you for so rapidly focusing the attention and efforts of the Senate Energy Committee and its staff on the problems faced by the natural gas industry, problems which can only get worse unless significant changes are made in the existing statutory framework. The Administration's Proposal provides bold, new initiatives in providing greater access for direct sales of gas, but those initiatives must be expanded and strengthened if this legislation is to result in an effective national market for natural gas.

By this presentation, NGEA has pointed out areas of weakness and suggested specific remedial action. We intend to supplement this statement with additional views and suggestions related to the access issue and to preferential dealings between pipeline companies and their affiliates. Thank you.

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The CHAIRMAN [presiding]. Senator Murkowski, I think it is fair, since you have been sitting here hearing the testimony and I just got back, that you should be able to ask a question first.

Senator MURKOWSKI. I am ready. Mr. Wilson, I assume that my recollection of your statement is that you are kind of a push, if you will, on your position in support of this legislation: you like certain parts of it and there are other pieces that you wish were changed.

Do you support it then or do—would you support it in its present form?

Mr. WILSON. In the present form, I would have to go back and talk to our members. One of the problems is that when producers get marketed out under the present bill, which many will do, especially based on my estimate of what the market clearing price would be and the fact that that is below sections 102 and 103 gas prices, that at the point they get marketed out and they have no place to go except back to the existing pipeline, they have to have very, very firm transportation and they have to be able to find the market.

One of the advantages, I think, to the administration bill which I did not mention in the statement because of the time is that it gets around the problem of contracts.

We have heard much, much testimony on the administration bill about specific contract provisions. I maintain that long-term contracts are themselves a problem because there is no way that you can design 20-year or life of the lease contracts, which we have been forced to operate with in this business.

There is no way you can design those contracts to be market responsive when you are having to compete with alternative fuels that prices change on a much more rapid basis.

Senator MURKOWSKI. So I am probably correct that——

Mr. WILSON. In the past they have worked because we have never had to compete with them. Gas has always been priced well below the alternative.

Senator MURKOWSKI. Your current position is kind of yet to be determined?

Mr. WILSON. With a few minor changes and strengthening of the access provisions, yes, we could support the administration bill.

Senator MURKOWSKI. Mr. Chairman, I think it is appropriate to pass on to you that during your absence it occurred to me that out of a panel of five we would probably get a majority leaning one way or another.

However, we seem to be split equally with the first witness, Mr. Dage, no; Ms. Britann Wallace, yes; Fuller, yes; McMillian a definite no, and Mr. Wilson rather neutral.

So that appears to pretty well substantiate what I have observed in the last 3 days.

The CHAIRMAN. That is better than average.

Senator MURKOWSKI. This legislation must have some merit or there wouldn't be such divergent opinions. I would like to refer to a question the first witness, Mr. Dage, who provided for the record a very comprehensive statement. Take note of page 3 concerning the current financial condition of the portion, I assume at least, of the independent deep well gas producers.

And my question to you, sir, is with the difficulties of doing business in a marketplace where we have seen a significant number of deep well producers experiencing difficulty for a number of reasons.

Among them were the economic problems. The reality is that they have had a difficult time operating in the current marketplace of control under NGPA.

I wonder if you could enlighten us a little bit why you think that a continuation of the status quo bill actually improve the position of the independent deep gas producers.

And I would also add in general terms that during this condition of decontrol with oil we have seen the oil crisis go down and yet more drilling is occurring.

I wonder if you could kind of relate the two equations, although they are not necessarily pertinent one to the other.

Mr. DAGE. Well, as I say, Mr. Chairman, I represent a company that is in the natural gas exploration reduction business and we have heard from a number of representatives of the oil companies this morning about their position on what had happened to natural gas legislation, none of whom are in our business predominantly.

Their gas is found in association with drilling for oil, and they take great pride in trying to tell us how to work out our problems.

Our main problems right now, Mr. Chairman, as independent producers of natural gas have to do with the—primarily with the fuel-use restrictions which have been placed on our supplies and with incremental pricing which have locked us out of markets for our product.

We feel that with lifting of the fuel-use restrictions, which the Hodel bill proposes along with a lot of other things, and with repeal of incremental pricing, markets would open up and we would have markets for our product and we can sell our product.

Also, we are of course suffering from the general decline in the economy which has caused a lot of natural gas users to shut down recently.

That, once again, is reducing demand. And we are probably suffering somewhat from our own success, which we predicted back in 1977-78 that given an opportunity and a proper incentive we could find massive supplies of natural gas that would more than serve the needs of the United States, and maybe we are suffering—we may have shot ourselves in the foot a little bit.

We were terribly successful and we increased supplies substantially and prices went down.

Senator MURKOWSKI. You found it but you can't afford to produce it?

Mr. DAGE. We can afford to produce what we have now.

Senator MURKOWSKI. What is the price?

Mr. DAGE. We can't afford to continue to look for it at $2.25.

Senator MURKOWSKI. What is the price you are receiving now for newly contracted——

Mr. DAGE. At the wellhead? In the neighborhood of $3 to $3.30 for new gas.

Senator MURKOWSKI. In your opinion, what would be the administration's bill, if enacted as proposed do—increase or decrease gas prices, increase or decrease gas reserves?

This is a question for the entire panel.

Mr. DAGE. I think that is comparable to the chairman's question opening the hearing today that he would like comments on price predictions and what would happen under various scenarios.

It is our opinion that if old gas prices go up, now gas prices naturally have to come down. With the reduction in new gas prices, you are going to have a corresponding reduction in drilling.

Reduction in drilling means you are going to have a reduction in supplies and reserve response, and eventually what is going to happen is prices are going to go back up similar to what they did in the mid-1970's.

Senator MURKOWSKI. Did you have a shortage then under that scenario?

Mr. DAGE. Yes, sir, I believe so. We won't have a shortage in natural gas reserves. We have got abundant reserves of natural gas.

We just want to be producing those reserves. And for those of you who are familiar with drilling in the provinces where we drill between 10,000 and 22,000 to 23,000 feet deep, you don't go out and drill one of these wells in 3 or 4 days as you do a 2,500- or 3,000-foot oil well.

It takes a couple of years from spud date to first sales on a deep-gas well. So even if the demand returned for natural gas and the price returned 4 or 5 years down the road, you are still going to have a short supply situation for a period of 24 to 36 months while you are going back out there and gearing up and getting the gas out of the ground again.

Senator MURKOWSKI. Now you oppose the legislation in its present form, but you would predict that if something isn't done, we can expect probably a shortage of gas in the foreseeable future?

Mr. DAGE. No; I wouldn't necessarily predict that. I think that if the Congress would repeal the Fuel Use Act and incremental pricing, there would be significant incentive for independent producers, such as GHK and the members of IGPC, to continue to explore foreign produced natural gas.

Our main problems now are lack of markets. Granted, the prices come down. We predicted that. Robert Hefner sat before this Congess in 1977, 1976, and predicted that the price would come down, as it has.

Senator MURKOWSKI. Thank you, Mr. Dage. I will again rephrase the question. In your opinion, what would the administration's bill, if enacted as proposed, aid—to increase or decrease gas prices, increase or decrease gas reserves?

Mr. DAGE. It would decrease new-gas prices, it would increase old gas prices, and would definitely decrease reserves.

Senator MURKOWSKI. Ms. Wallace.

Ms. WALLACE. Basically, I concur with Mr. Dage's answer. The old-gas prices will come up and new gas prices will come down, as we are seeing happen right now as purchasers exercise the market outs under their contract.

It seems as if the new-gas prices are tested when they reach the point of the average of No. 6 fuel oil minus transportation cost.

And the latest figures that I have available, the average transportation in the country—these are fall prices—was $1.40, and the average of No. 6 was about $4.45.

So you subtract the transportation from the average of No. 6. The bottom line price is $3.05. As these are roughly September prices, I think at about that time the September 102 price was around $3.20.

So that is the price that we are seeing the downward pressure on 102 prices, and I suspect that is the price we will continue to see, whether it continues to regulated or it is deregulated.

Senator MURKOWSKI. I think what we are looking for is average wellhead price.

Ms. WALLACE. I believe the average wellhead price is about——

Senator MURKOWSKI. Are the consumers better off?

Ms. WALLACE. Yes, sir, I think that they would be.

Senator MURKOWSKI. You think they are better off?

Ms. WALLACE. I think the overall prices will be lower, that we can reassure our markets.

Senator MURKOWSKI. Thank you. Mr. Fuller.

Mr. FULLER. I would agree with that. Overall prices would come down.

Senator MURKOWSKI. Mr. McMillian.

Mr. MCMILLIAN. I think the price of new gas would decrease in relationship to what you escalate the old-gas prices to.

However, I think we are facing a limited supply, and I think in time that the bubble or deliverability bubble that we are now experiencing will expire and that will be a direct function of the economy and other factors, but initially yes, your answer is.

Senator MURKOWSKI. You would agree with the others that the price will decrease?

Mr. MCMILLIAN. Initially.

Senator MURKOWSKI. In the short period, and that would obviously be in the best interest of the consumer.

Mr. MCMILLIAN. No; to the consumer? No; you are elevating the low price gas from, say, 80 cents or levels like that to very high prices, and so it is very detrimental to the consumer by elevating and deregulating the low gas prices, like the figures I mentioned.

It amounts to billions of dollars on just our system ourselves, some $13 billion, the two pipeline systems that we directly operate.

So by deregulating old gas, it is very detrimental to the consumer.

Senator MURKOWSKI. Well, then, you have a difference of opinion from Mr. Fuller and Ms. Wallace.

Mr. MCMILLIAN. I think it is very detrimental——

Senator MURKOWSKI. I want to make sure we understand the question. The question was, in your own opinion, would the administration's bill, if enacted as proposed in the short term, increase or decrease gas prices.

Mr. MCMILLIAN. For new gas, it would decrease the price of new gas, which would reduce the incentive to drill new gas and look for new supplies, but it would be very harmful to the consumer because the overall price would be elevated.

Senator MURKOWSKI. Mr. Wilson, the same question.

Mr. WILSON. My answer to that is overall I feel like if you decontrolled everything, that the average gas price would be about equal to the current mixed price today, although the effect is going to be different on different systems, depending on what their particular mix is.

I think that one of the things that this debate has concentrated on on this bill is field-level prices, and assuming that that is all that the consumer is looking at. Under freeze proposals, under a lot of other things, that we have heard proposed today, it totally disregards the fact that one of the largest components of the increase over the last 2 years has been increased cost of transportation and distribution, which is a function of both reduced demand, slightly increased costs.

And consequently, you have fixed cost spread over less and less gas going through the system. And that has been a very major part of the increase in consumers' bills. And I do not think that people should make the assumption that even if you freeze the PGA level, which the adminstration's bill proposes, that the consumer prices are not going to continue to go up.

Beause there will still be allowed under the bill for a general rate increase provisions as now currently we have in the Commission rules. We have concentrated on producer prices like they were the entire problem, and they are not. Consumer bills have gone up, while our revenues have gone down.

And I would like to make one comment. We also, the company that I work for, is an independent producer. We are predominantly a natural gas producer. We would love to be selling more gas than what we are. We are about 60 percent curtailed at the present time.

And I can guarantee you as an independent gas producer, we feel very strongly that we cannot stay with the current system, because that is almost an assured diaster for our markets. And we do not see it getting any better under the current system.

Gas ends up as a Tiffany product. The only people that can buy it are those that cannot get off of it, that cannot go to something else. And as an industry, whether we are deep gas producers or low cost gas producers, we cannot afford that.

Senator MURKOWSKI. Thank you, Mr. Wilson.

Mr. McMillian, you stated in your testimony that the pending legislation may have a profound effect on the Alaskan natural gas transportation system.

I am sure that you would be disappointed if I did not ask you whether or not you are suggesting that the enactment of the President's proposal would make the Alaskan natural gas transportation system somehow uneconomical or unlikely to be built.

Obviously, you indicated it in your statement, not I, so I am not bringing it up. I am responding to a signal that appeared to be there.

Mr. MCMILLIAN. Well, I think that if you would throw all of the contracts up in the air at a date certain, whenever that date is, and say everybody grab their card as they come down, I think that the chaos that you would create in our industry, and the burden that you put on our industry—this bill is very punitive to the natural gas transportation business.

So I think that the ability of natural gas transmission companies to be very effective hereafter would be severely limited by this bill, since you are putting the burden on the transmission companies to solve the problems, and be the linchpin, as Secretary Hodel said, to revising the pricing contracts and mechanisms throughout the United States. It will not happen that way.

So yes, it would be determental to them with the chaos that you would create in this industry, if that happened.

Senator MURKOWSKI. Associate them all together then, and you would have a substantial problem?

Mr. MCMILLIAN. A substantial problem, yes. I think it is an ill-thought out bill.

Senator MURKOWSKI. You say in your testimony that you have not yet been able to bring the gas price crisis under control, and that is a quote attributed to you. You note that under existing law that you cannot renegotiate, and producers are not willing.

In your opinion, would not the administration's proposal solve that problem, in that it would enable you to exercise a market-out for gas which you were unable to renegotiate?

Mr. MCMILLIAN. If you mean will we be able to renegotiate our contracts between now and the time when you throw them all up in the air, I do not think so. Because by the time that you get through with this bill, you will probably be into 1984. And then you are looking at 1 year. Why not wait for 1 year until they are all thrown up into the air to see where everybody goes.

I do not think that you get much incentive or much leverage for us to negotiate with.

Senator MURKOWSKI. I do not know about the chairman, but I am not going to sit here until 1984.

Mr. McMillian, you call the administration's proposal indefensible, and claim that it will result in unnecessary price increases. You say that it would jeopardize an adequate and secure supply of gas. You state that it will only exacerbate the present prices.

Obviously you are well-versed in the present political system, and you recognize, just as I do, that there is little chance that the Congress will not act somehow on the issue.

Mr. MCMILLIAN. Yes.

Senator MURKOWSKI. If the option is between the administration's proposal and a price freeze, or even a price rollback proposal, which some Members of the Senate prefer.

Which would you support?

Mr. MCMILLIAN. None. I think that you need something else.

Senator MURKOWSKI. What do you suggest?

Mr. MCMILLIAN. I think that you need to amend or eliminate the take or pay and the price indexing. Then give us an even chance to go in and negotiate contracts, and the high take or pay contracts that are giving us our particular problem, and other pipelines their problems on the pricing of their gas in their market area.

Senator MURKOWSKI. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you again, Senator Murkowski.

Again, I apologize to the panel for having been necessarily absent while you were summarizing your statements. I have had the opportunity, of course, to go through them to some degree myself.

I would like to start with one of the major features of the bill. Certainly, it is the most controverisal aspect, I believe, the decontrol of old gas. The bill would permit producers of old gas to abrogate their contracts on January 1, 1985. The argument is made that virtually all old gas contracts would be abrogated, and the producers would sit back, and wait for the highest bidder. They would eventually sell the gas at a much higher price.

If the producers are permitted to abrogate their contracts, to what extent do you think they could afford to hold their gas off the market, and wait for prices to increase before resuming their production?

Mr. DAGE. Mr. Chairman, with respect to the old gas, which has been pointed out here today, it is primarily owned by the major oil companies. The major oil companies have phenomenal staying power financially. Therefore, I think that they could stay as long as economics dictated before they renegotiated those contracts, and they would get the highest price possible for them.

With respect to that small percentage of old gas that is held by independents who need the cash flow, I would assume that they would probably come to the table a lot sooner. The same circumstances would apply today.

We as an independent, and most independents, have voluntarily gone to our buyers, and opened renegotiations of contracts on the basis of take or pay, and price, and so on. The ones that are holding out on those, and I think that Mr. McMillian could probably underscore this, the ones that are holding out on renegotiation of contracts are those who are primarily oil companies, who have tremendous staying power financially, and they do not have to come to the table.

We have got to have that cash flow to service debt. Therefore I think that because most of the old gas, 80 percent of it as estimated by the Secretary of Energy, is held by major oil companies, who have tremendous financial staying power. I do not think that you would see them coming to the table very rapidly for small increases. They would hold out for big increases.

The CHAIRMAN. Ms. Wallace.

Ms. WALLACE. Mr. Chairman, the independent is in the same situation. We have a similar position as his company does. The independent as operator cannot afford to delay cash flows in the times that we are having right now. In addition, he has partners to answer to, to whom he must represent that he is a diligent and prudent operator. There is no way that he could hold gas off the market and fulfill that responsibility to his partners.

The CHAIRMAN. You believe that the big companies would?

Ms. WALLACE. I believe that the big companies have more capability of being able to do that.

The CHAIRMAN. I am sure that they have more capability. The question is would they?

Ms. WALLACE. I really do not know, Mr. Chairman.

The CHAIRMAN. Mr. Fuller.

Mr. FULLER. The independents, of course, as everybody has said are faced with a cash flow problem. And to a much less extent, the majors are. And I think that the determining factor possibly with the major companies would be the terms of their leases. And they would be putting those leases in jeopardy, if they tried to hold them off the market. I think that is a factor that would stop this from coming into play.

The CHAIRMAN. What happens with the royalty owners?

Mr. FULLER. That is what I mean. That would put their leases in jeopardy, a failure to continue to produce the properties. And I think that this is a factor that could enter into it, and would make that as real an issue as some people would lead you to believe.

The CHAIRMAN. Mr. McMillian.

Mr. MCMILLIAN. I think that the oil companies would have the financial capabilities to pay shut-in royalty clauses, or whatever is necessary to protect the lease, and negotiate it as long as they wanted to negotiate to get the price that they wanted to.

It is a matter of opinion. You know, I say major oil companies. Some of them have been very responsible. The sales have been very responsible. Unfortunately, the ones we have been negotiating with, we have not had much luck.

And I would imagine that it depends on the oil company. I imagine that it depends on the circumstances, and it depends on what he wants for the gas. But they do have the financial resources to sit there and wait until the highest price does come along. And it would be an individual decision.

The CHAIRMAN. Mr. Wilson.

Mr. WILSON. I basically agree with what most of the other panelists have said. I do not think that the independent sector can afford to withhold gas production, because of the cash flow problems, even if they had the ability to do it under the state rules, which you certainly do not. And with royalty owner demands, you do not have that ability.

The contracts problem has been alluded to a couple of times. And I would like to make the comment that in the renegotiation process, if you are a company, whether you are an independent or a major, and you are sitting there with a mixed price for all of your gas that is not out of line with the market price, you are very reluctant to give up your higher priced gasoline.

We are not talking about getting any relief on the lower priced gas, because you tend to look at it from an overall basis, and say I am not the problem.

The CHAIRMAN. Mr. Dage, you made a comment earlier that you are selling new natural gas now on current contracts and current sales of $3 to the $3.30 level, is that correct?

Mr. DAGE. Well, it is partially correct, Mr. Chairman. That which we have sold recently, which is very little, has been in the $3 to $3.30 area.

The CHAIRMAN. Is that section 102 gas?

Mr. DAGE. That is all new natural gas regardless of depth or pricing category.

The CHAIRMAN. Does that include some of the deep?

Mr. DAGE. Yes, sir.

The CHAIRMAN. And it is still selling at that rate?

Mr. DAGE. Well, that is the offering price.

The CHAIRMAN. Well, is it selling?

Mr. DAGE. You bet. Once again, for the same reasons that I stated previously, an independent who has completed a deep well, and who has an investment in that well, does not have the financial staying power to withhold that gas from the market.

If we can get a market for that gas, that is in any way near reasonable, and we will not go indefinitely in the hole, then we are going to do the best we can to sell that gas. Therefore under current conditions, we are talking in terms of $3 and $3.30 for all new gas.

There is not any such thing any more, in my opinion, Mr. Chairman, of 102 gas, or 103 gas, or tight sands gas, or any of those things. It is all new gas, and it is all selling for about the same price.

The CHAIRMAN. Mr. McMillian, I understand that you made some comment about the difficulty that you had in providing supplies to the Kansas City market. The information that I have, and I am not sure that you gave the figure, but the information that I have is that it is selling at $5.60 in the Kansas City market.

Is that correct?

Mr. MCMILLIAN. No, sir, $4.66. And we are competing with $4 fuel oil.

The CHAIRMAN. My understanding is, and I will have to look at the other figures in light of your correction, because this information came from the Energy Information Administration as of December of 1982.

Is your $4.66 the city-gate price or the delivered price?

Mr. MCMILLIAN. That is the industrial rate. You are talking about the residential rate.

The CHAIRMAN. What is the residential rate then?

Mr. MCMILLIAN. That is the $5.

The CHAIRMAN. The $5.60 would be correct?

Mr. MCMILLIAN. Yes, that is correct.

The CHAIRMAN. It is interesting to note, and I know that pain is a relative thing, as it depends on what you are measuring it against, that that rate is a median among most of the major cities.

Atlanta is $5.80; Baltimore is $6.68; Boston, $7.40; Chicago, $4.98; Dallas-Ft. Worth, $5.40; Denver, $6.40; Los Angeles, $4.63; Minneapolis-St. Paul, $5.68; New York, $8.24; Philadelphia, $7.35; Portland, $6.73; St. Louis, $6.32; San Diego, $5.13; and Washington, $7.89.

Mr. MCMILLIAN. I have been telling them what a good deal that they have, too. But let me tell you what is happening to the market.

The CHAIRMAN. I thought that I would help you out a little.

Mr. MCMILLIAN. I will make a press release on that. But we are losing our industrial loads, because we are 60 cents higher per million Btu. That was the domino effect. And, of course, our residential costs are going up appreciably over that figure that you mentioned.

The CHAIRMAN. Are there members of the panel who are anxious to get away. There is a vote on the floor. I have a couple of more questions, if you could wait until I can go over there and vote, and come back and ask a couple of more. I hate to hold you.

Mr. FULLER. We would be willing to stay.

The CHAIRMAN. All right. We will be in recess for a few minutes.

[Whereupon, a short recess was taken.]

Senator MURKOWSKI. We seem to have run into a situation where I do not have any more questions, but the chairman does. So we are going to wait for the chairman. You can continue to relax, or kibbutz, or whatever is fair.

[Whereupon, a short recess was taken.]

The CHAIRMAN. I think we have a few minutes between now and the next rollcall vote.

One of the questions that came up this morning is a question that is not addressed by the legislation that has been proposed by the administration, and that is supplies that come from outside of the United States.

And Senator Percy particularly raised that issue in his testimony. It is also, of course, in the bill which he has introduced, and is the subject of a resolution which a number of us have cosponsored with respect to negotiations particularly with the Canadians.

As Mr. McMillian pointed out earlier, a large proportion of the supply that comes into the State of Idaho comes from Canada. It was nearly 70 percent. I think that as they have lost volumes, it is down about to 60 percent in my State now.

Is there a way in which we can legislate to put pressure upon the foreign suppliers, or is that simply a matter of negotiation; what would happen if we fixed a price by statute—would we still get supply, or would they simply cutoff supply?

Maybe I will start with you, Mr. McMillian.

Mr. MCMILLIAN. I think that if you legislated a set of circumstances that another foreign government would have to fulfill to sell their product here, naturally their national pride and national interest would not allow them to do that.

The national energy policy of Canada and the price differential that Senator Percy was talking about was established so that the Canadians would be convinced that the energy that they were exporting would equate with the energy that they were importing.

That was kind of the basis of establishing the price that they did. And it had no relationship to what the actual market conditions should be. Because at that time, our total domestic gas supply was much lower than competing fuels, and it did fit in and roll into the marketplace. Today it does not.

And I think that by setting a set of circumstances here on take or pay, and they look at us, and if you have 90 percent take or pay here in their contracts, they want 90 percent in their contracts. If we had a lower figure of 50 here, I am sure that it would give them a political reason to amending their export license to a lower figure.

Also, we are trying to get them to change their pricing mechanism of uniform barter pricing. We think that that is very discriminatory to the places in the West, and in California, and in our area. And it subsidizes the gas to be exported to the East.

It is not a good policy. They recognize that. But we made them do that in the early days for another reason. And we should encourage them to adjust their marketing policy, so that there is differential pricing in relationship to the distance transported from Canada.

I think that if you would set backgrounds for them. And then, of course, we are trying to establish a gas contract where the gas fits into the market. And then we have a net back feature to them. And that is why we came up with the $3.40 price, because we think that we can sell their gas in our market area at the border at that price.

And I think that you have to work on systems like that. But for us, we have just flat told them that we could not take it. We are not fulfilling our contracts. Other people have, too. People's Gas cut them off, United Gas cut them off. A lot of people just cut their Canadian exports to zero regardless of contracts. Financially, there is nothing else that they can do.

They are saying force majeur. If they get more gas in the pipeline, they will blow it up. But you can really encourage this by set policies. But for us to dictate the policies, as you well know, you have been there, and you helped us immensely in your personal contacts there.

But I think that it has to be in that way, and almost government to government, State Department to Foreign Ministry type, and Trudeau to Reagan type talks.

The CHAIRMAN. Are there others of you who would like to comment; Mr. Wilson?

Mr. WILSON. Yes; I would on the import side. One of the problems with trying to set a firm price for imports is that the gas markets are going to have to be very fluid in the future, if they are going to retain their markets and be competitive with other energy sources.

To try to set a price, you would be holding hearings every 6 months to establish a new Canadian border price, and going through all of the agony again. We feel that the best way to put pressure on both imported prices as well as high cost gas prices is through the equal access mechanism, whereby users of the high cost sources of gas, who right now have very few choices but to buy that gas have access to the large amount of lower priced gas certainly available all over the country, and to the extent that they can be freed up to go buy lower priced gas that is available from producers.

As the high cost gas and the imported gas begins to lose its market, you will begin to see contracts being renegotiated. We feel that is an excellent market ordering mechanism. Because at the point that people can go find lower priced gas than what they are currently, they will do that.

The CHAIRMAN. Are there any further comments; Mr. Fuller?

Mr. FULLER. I do not know what is available, and what can be done. Of course, under international laws dealing with other governments, whatever can be done from your level can be appreciated. Because we are subsidizing the high cost gas with our weak market. And we are also not able to produce our full capacity which we need to produce for our cash flow. So whatever you can do would be greatly appreciated.

Mr. DAGE. I would echo those comments, Mr. Chairman. As a producer, we find it very difficult to understand how we can be importing gas from Mexico and Canada at $4.94, when we have a wellhead price that is below that, $1.60. And our markets are going away. We find it difficult to compete in that kind of a situation.

The CHAIRMAN. One of the assumptions that Congress made at the time that the 1978 act was passed was that gas was in short supply. It was a premium fuel. It was the premium fuel primarily in the home heating market. And therefore the market clearing price was dictated by the home heating market price, and the alternatives at that level.

There has been some reference made here today to the loss of market in the industrial market rather than the home heating market.

Does that indicate that it is the industrial market price rather than the home heating market price that is the market clearing price we ought to be looking at?

Mr. **Dage**. I would say that that is partially true. The problem that exists now, Mr. Chairman, of course, is that as your industrial markets go away, or as you have artifical restrictions on use of natural gas, then the unit cost of natural gas has to go up to the home heating user of natural gas.

Those who heat their homes with gas and cook with gas do not have as readily available an alternate fuel as industries do.

The **Chairman**. You anticipated my next question.

If that is true, if you lost industrial markets, what happens to the home heating market consumer? But if what we are looking at are mechanisms of whatever duration they may be that affect price, and if we in the Congress should decide that the mechanisms ought to be directed toward price fixing of some nature, should we be looking at the home heating market or the industrial market for that benchmark or that level?

Mr. **Dage**. That is a very difficult question. I do not know. If you are talking about a market clearing price, then that is a price that would clear all markets, I would assume. I do not think that it would be fair to artificially hold up high prices for home heating users, because that is a captive market, necessarily. I think that it would have to be a totally market-clearing price that would be a blended price among all users.

Now there again, I imagine Mr. McMillian might have a different response to this in trying to compete for his industrial markets under current conditions. He has to be competitive with No. 6 fuel oil, obviously, in order to hold those markets.

But I would assume that what you are really trying to achieve is a market-clearing price that takes into account all end use of natural gas.

The **Chairman**. Ms. Wallace.

Ms. **Wallace**. Mr. Chairman, the imperative in the industry right now is to remain the markets that we have lost. And we have lost a significant percentage of our industrial markets. I feel that if we can regain that sector of our marketplace, that the benefits would flow through to the residential users.

I see the supply requirement necessary to continue with drilling, and the prices will be set to encourage that activity.

The **Chairman**. If you do not have an industrial market, the price to the consumer will rise for two reasons then.

Ms. **Wallace**. Yes, sir.

The **Chairman**. Mr. Fuller.

Mr. **Fuller**. The primary reason, as I see it, that we are losing our industrial customers are in the Fuel Use Act and forcing them to convert, and in the incremental pricing which was an effort to keep the home-heating-oil prices down. The policies of trying to stack a market one way or the other are coming back and hounding us, and that is the reason that we are losing these customers.

And as everybody else has pointed out, the fixed costs in these pipelines have to be distributed to whoever consumes it. So if we lose that industrial customer, then that just adds back to the consumer's price.

I think that the Fuel Use Act and the incremental pricing created this distortion in the market.

The CHAIRMAN. Mr. McMillian.

Mr. MCMILLIAN. I agree with about all that has been said here. Except that in the residential market, there is 18 to 25 percent of these people who are not paying, or are not capable of paying their gas bills today. So we have gone beyond that segment of the market's capacity to pay.

So I guess that the clearing price, 25 percent of the clearing price, would be below what we are charging the residential users today. And then we talk about being competitive with No. 6 fuel oil. That is not always the case in a lot of your industrial markets.

All of the fertilizer plants in the Midwest are shutting down. They are telling us that they will need $3.10 gas to compete with fertilizer imported from Mexico and Canada, where we are paying $4.95 for their gas.

So there needs to be a differntial market with a different pricing structure. It is very hard to get through a lot of State regulatory agencies.

The CHAIRMAN. Mr. Wilson.

Mr. WILSON. I think that as an industry, we cannot afford to continue to lose our industrial markets. I do not know what the current numbers are. But I would guess that about half of our current demand is residential and commercial, and about half of it is industrial.

It is just too important to us to maintain those markets. It is also extremely important to the residential user to have that industrial user on the system to help carry those fixed costs.

I think that part of the reason that we have lost industrial load in addition to the weak economy, and in addition to the competition in the feritlizer business, which Mr. McMillian mentioned, and had been a very major part of our natural gas demand, one of the problems that still needs to be addressed is the rate structure within the various States where the way charges were allocated by the local public utility commissions were skewed to overcharged industrial users in many, many cases knowing that it would reduce the cost to the residential and commercial users who were the ones that had the most political clout.

That very rate structure is now serving to comeback and haunt the residential and commercial user, since as that industrial load goes to another fuel, they lose all of the help with the fixed costs of distribution. That has to be addressed, we feel, eventually in getting our industrial markets back.

It is not just not simply producer contracts. We have a serious problem as an industry, and it goes all the way through the system.

The CHAIRMAN. I hope that you are not asking us to take over the job of the State regulatory commissions.

Mr. WILSON. No, not at all. But I think that the State regulatory commissions need to recognize that they cannot overcharge the industrial users too far, or that they are going to lose them.

The CHAIRMAN. Thank you, very much. I appreciate your patience, and your willingness to sit around here all day waiting for your chance to testify, and to give us the benefits of your views. We very much appreciate having those views.

This committee will be in recess for about 5 minutes. There is another vote on the floor of the Senate. Then we will reconvene and hear the last panel.

Thank you, very much.

[A short recess was taken.]

The CHAIRMAN. The committee will come to order.

Our final panel of the day is George Lawrence, president of the American Gas Association; the Associated Gas Distributors represented by Mr. Charles Zeigler, president and chief executive officer of the Public Service Co. of North Carolina; Mr. C. W. Cooper, chairman of the United Distribution Companies; the city of Albany, Ga. represented by Mr. Walter Rodemann, manager of the water, gas and light commission; and Mr. Jerome McGrath, president of the Interstate Natural Gas Association of America.

I see somebody else sitting there with a name in front of him, so I assume that somebody has been added to our panel.

Mr. MORING. Yes, sir. Mr. Chairman, I am Fred Moring, and I am counsel for Associated Gas Distributors.

The CHAIRMAN. Thank you, very much.

I think that you all know that the 5-minute rule is in effect. And I do not suppose that at this hour of the afternoon, you object very much to that.

Mr. LAWRENCE. Not at all.

The CHAIRMAN. Mr. Lawrence.

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, AMERICAN GAS ASSOCIATION

Mr. LAWRENCE. I am George Lawrence. Today, of course, the spotlight is on the administration's bill. You, Mr. Chairman, have said that it is a good starting point for debate, and it addresses all of the key issues. We agree with that assessment. We are glad that it was introduced.

The bill does provide legislative momentum that is surely needed. Because we must respond to the consumer discontent, and we must be able to respond to the volatile industrial market, and possible significant further reductions in oil prices.

In my opinion, in answer to the question that you just asked the other panel is the market clearing level is today that which will compete in the industrial market. If we lose more industrial markets of imported oil, all consumers suffer, and so does national energy policy goes.

The administration apparently shares our belief. It is a bill that contains certain of the basic concepts needed to provide price relief, although they add other provisions which more than cancel them out.

The needed concepts include a market sensitive cap on indefinite escalator clauses, repeal of incremental pricing, a fuel use act, and acknowledgement of the take or pay problem, but far from adequate solutions.

Unfortunately, however, this is a half and half bill that provides price relief on the one hand, and takes it away, actually more than takes it away with the other. So we oppose the bill in the present form.

Old gas decontrol alone would more than wipe out the price reductions obtained through other provisions of the bill. Although you have heard testimony to the contrary, old gas decontrol would raise gas prices in our opinion substantially.

At the same time that it generates price increases at the wellhead, the bill would cripple our industry's ability to deal with these price increases by imposing rigid PGA ceilings. The ceilings would not prevent the cost impact of old gas decontrol from reaching the consumers, but they would simply slow things so that the financial viability of our interstate pipelines and their ability to compete with other purchasers for new gas supplies would be impaired.

Finally, the bill would increase residential gas bills in a way that is less obvious than old gas decontrol. The bill's mandatory contract carriage provisions, which are really common carriage provisions, would in concert with other provisions allow literally hundreds of new buyers to purchase gas at the wellhead.

Now this may sound appealing in theory. In fact, what it means is that every powerplant and industrial user in the country can make its own deal with the producer, and then go to the FERC and ask them to make the myriad of judgments regarding the efficient system operation, service obligations, priority service to residential users, operation of storage facilities, et cetera.

This can become an administrative nightmare, and entirely disrupt our million-mile transmission and distribution system, which is a major national asset, and the envy of energy-using nations throughout the world.

At a time when we urgently need this committee and Congress to focus on solving the pricing problems, and for an orderly transition to a deregulated field market for new exploration, we just do not need this distraction and debate over a major and indeed highly undesirable structural change in our industry.

So we must oppose the administration's bill so long as it contains old gas decontrol, rigid PGA ceilings, and common carriage provisions. We believe that the country needs a bill that focuses on price relief without adding the costly burdens of old gas decontrol and experimentation with the restructuring of our industry.

At the same time, we should avoid the other extreme of reimposing price controls on new gas. Despite the transitional problems of which we are all painfully aware, an enactment of the NGPA has shown that new gas decontrol can help the Nation's gas supply, just as the period before NGPA enactment showed that price controls will lead to a shortage.

The columnists disagree on a lot of things, but they all agree on how to start a shortage, and that is impose price controls. So new legislation should not put us back on the road to a discredited era which this committee and this Congress worked so hard to get us out of.

In conclusion, Mr. Chairman, we urge this committee to approve responsible price relief legislation including a cap on escalation clauses, a temporary take or pay ceiling set at 50 percent of deliverability, removal of all market restraints, immediately effective market-out authority for contracts governing relatively inexpensive gas, and standards for approving post-enactment contracts by FERC should expand the fraud and abuse standard of NGPA to include a prudence standard.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, very much.

[The prepared statement of Mr. Lawrence follows:]

TESTIMONY OF
GEORGE H. LAWRENCE, PRESIDENT
THE AMERICAN GAS ASSOCIATION
BEFORE THE
U.S. SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
ON WELLHEAD PRICING POLICY FOR NATURAL GAS

March 11, 1983

Introduction

Mr. Chairman and Members of the Committee:

I am George H. Lawrence, President of the American Gas Association. A.G.A. is a national trade association, composed of approximately 300 natural gas distribution and transmission companies, serving over 160 million consumers in all 50 states. Together, these companies account for nearly 85% of all natural gas utility sales in the nation.

Since the Natural Gas Policy Act (NGPA) -- with its incentives to find and produce new gas -- was passed in 1978, there has been a dramatic improvement in the U.S. gas supply outlook. This progress, however, has been clouded by major increases in gas prices. More troubling, these price increases have occurred in an environment of excess gas supplies, despite the predictions of classic economic theory. All of this has been exacerbated by falling demand for gas in the industrial sector caused by the recession and more intense competition from oil.

These developments are difficult, if not impossible, to explain to consumers. We have worked for the partial solution of adequate Federal funding (as well as private sector funding) for fuel assistance to those with low and fixed incomes. While we continue to work for such programs, we recognize that a more comprehensive solution is needed.

The primary reason that retail gas prices are increasing is because of increases in the wellhead price of gas. According to a recent A.G.A. analysis entitled "Cost Components of the Average Gas Price", in 1981 60% of the average retail price of gas could be attributed to purchased gas costs, compared to 32% in 1971. While about half of the 1982 (September 1982 contrasted with September 1981) residential price increase is attributable to the wellhead increase directly, increases in severance taxes, sales taxes, and pipeline compressor fuel costs are also directly attributable to the wellhead increases. Therefore, nearly 60% of the residential gas price increase in 1982 is either directly or indirectly attributable to the increase in the wellhead price. To illustrate the impact of higher wellhead costs and taxes over the last ten years, costs under the control of gas distribution companies (all costs other than purchase gas costs and taxes) increased at an average of 5.7% per year -- almost two percentage points slower than inflation.

In addition to sharply higher purchased gas costs, the gas industry also faced rapidly increasing tax costs. The regulated gas industry has a significantly higher tax burden than the average for all U.S. industries -- with federal, state and local taxes representing 95% of net income for the gas industry versus 60% for the average for all industries.

Overall, 29% ($1.17 per Mcf) of the consumer's 1981 national average gas price of $3.98 is attributable to federal, state and local taxes. We have attached a copy of our study.

Many parties have come forward with solutions to this problem of rising wellhead prices. Some have proposed recontrol and others have proposed total decontrol of wellhead prices. Neither prescription will cure the gas markets because both recontrol and old gas decontrol have the same harmful side effect: they are counterproductive from a supply standpoint. Recontrol advocates want to limit wellhead prices directly; total decontrol advocates want to raise old gas prices but force new gas prices down simultaneously. In either case, new gas prices bear the brunt of price reductions and supply incentives are seriously undercut.

There is no reason to trade these supply incentives for total decontrol or recontrol when there is a better option. That option is to deal with the heart of the problem -- gas contract clauses -- while leaving the NGPA wellhead pricing incentives intact.

Such a focus on price relief measures -- without the added factors of old gas decontrol and other sweeping regulatory and industry structure changes -- also offers the tactical advantage of reduced legislative complexity. As it stands now, the Administration bill's complexity -- along with its provisions addressing issues where deep controversy exists -- is likely to generate long debate at a time when expeditious action is needed.

Fortunately, A.G.A. is not alone in pointing Congress toward a "middle ground" between the extremes of recontrol and total decontrol. For example, we are heartened that Senator John Heinz of Pennsylvania has introduced S. 689, the Natural Gas Policy Act Amendments of 1983. We are still in the process of assessing his bill, which was introduced only a week ago, and our very preliminary assessment is that its proposed responses to current problems are somewhat more sweeping than our own policy recommendations. However, we are pleased that the Senator has concentrated on measures which would bring gas prices downward -- without embracing the costly baggage of old gas decontrol (and industry structure changes) or moving to the opposite extreme of reimposing shortsighted wellhead price controls on new gas beyond 1985.

We at A.G.A. have formulated our own legislative framework for taking such an approach. This legislative framework -- as adopted by our Board of Directors -- can be outlined as follows:

1) Title I of the Natural Gas Policy Act

   Title I of the Natural Gas Policy Act need not be reopened. This means that there should be no deregulation of old gas, and no acceleration of deregulation of so-called "new, new gas" or of NGPA new gas to be deregulated 1/1/85.

2) Incremental Pricing and Fuel Use Act

   Title II of the NGPA (incremental pricing) and the Fuel Use Act should be repealed, in the manner provided verbatim in S. 615 and H.R. 1760.

3) Take-or-Pay Clauses

   Take-or-pay obligations in existing new gas contracts should be reduced for three years to a ceiling of 50 percent of deliverability. Language regarding appropriate make-up provisions should be included. Exceptions to this ceiling may be allowed for drainage, associated gas, transportation considerations, other operations constraints, and producer financial hardship. During this 3-year period, pipeline/distributor minimum bill requirements should be adjusted to reflect the pipeline take-or-pay changes made pursuant to the above authority.

4) Indefinite Price Escalator Clauses

Indefinite escalator clauses (including area rate clauses and so-called "maximum lawful price" clauses) should be capped as of the date of enactment with a floating cap reflective of current market conditions. This mechanism would: (a) cap indefinite escalator clauses that will be triggered by new gas decontrol in 1985 at a level reflective of market conditions at that time; and (b) immediately allow Section 102 gas flowing under existing contracts, that would receive the NGPA Section 102 ceiling price through the operation of an "area rate" or "maximum lawful price" clause, to decline to the floating cap.

5) "Market Out" Option for Section 107 Gas Contracts

There should be a one-time "market out" for Section 107 gas. It would include a one-time bilateral (i.e., either party unilateral) termination option for pipelines and producers within 12 months; pipelines would have the right of first refusal.

6) Third Party Most Favored Nation Clauses

Most favored nation clauses should be permanently banned, in existing and future contracts, as being inherently anti-competitive and against public policy. This is part of the general strategy to allow each pipeline to be responsive to its own market and for each contract to affect only the parties thereto.

7) Pipeline Accountability

The present PGA passthrough standards of "fraud and abuse", as contained in the NGPA, should be strengthened for new contracts to include a prudence standard.

8) Intrastate Pipeline Access to Otherwise Jurisdictional Gas

In principle, intrastate pipeline access to otherwise jurisdictional gas should be enhanced. This could include access to offshore gas, imported gas, or short-term interstate pipeline surplus gas (via a "reverse §311(b)").

GENERAL ASSESSMENT OF THE ADMINISTRATION'S BILL

S. 615, introduced by Senator James McClure of Idaho, embodies the Administration's proposal -- as does H.R. 1760, which was introduced in the House by Congressman Tom Corcoran of Illinois.

This bill approaches the NGPA in complexity and, for this reason, we have not fully assessed every specific aspect of the bill. However, although we may well convey a more detailed assessment to you in the future, we are prepared to offer a general assessment:

1. We agree with Chairman McClure's public comments that the Administration bill addresses all the issues and deserves serious consideration as a good starting point for legislative debate. In particular, we are pleased by the bill's efforts to provide price relief for consumers through creation of a "cap" on indefinite escalator clauses and a take-or-pay ceiling. In addition, we endorse the provisions which would repeal incremental pricing and the gas use restrictions in the Fuel Use Act -- and we also support the repeal of the price control reimposition authority in NGPA Section 122.

2. Nevertheless, we cannot support the bill in its present form. Our major objections are threefold: a) the proposed rapid decontrol of old gas; b) the proposed ceiling on pipeline PGA passthrough; and c) the proposed authority for the FERC to order mandatory pipeline transportation -- on behalf of a greatly expanded number of potential purchasers at the wellhead.

3. We oppose old gas decontrol because it would unnecessarily increase gas utility bills at a time when consumers are already heavily burdened and when the gas industry is already losing load to oil. To the extent that consumers are shielded from these price increases by the proposed PGA ceiling, interstate pipelines would be "squeezed" between significant price increases and the proposed PGA ceiling. Further, when "overruns" of the PGA ceiling are finally approved by the FERC as "just, reasonable and prudently incurred", the "overruns" would be passed on to consumers (through the distribution system) in the form of higher utility bills.

4. The Administration bill implicitly reflects the theory that old gas price increases would be fully offset by declines in prices paid for new and deep gas. We call this the "seesaw theory" -- and we do not believe that it would work with full efficiency in practice. Further, even to the extent that it did work, it would not work within the time limits necessary to permit an orderly transition to a deregulated market -- especially since the transition would be occurring during a time of critical competition in the volatile industrial markets.

When one attempts to apply the "seesaw" theory to the real world, the practical problems become evident. It is abundantly clear that, under total decontrol, producers will -- in most cases -- have the leverage needed to bargain old gas prices to a sharply higher price level. It is far from clear, however, that pipelines will have the leverage needed to negotiate the new and deep gas prices downward to the extent needed to avoid a net increase in average wellhead prices. For example, let us use 1982 price data (rather than speculative price projections for 1985), assume an oil price of $28.00 per barrel, and see how the theory would supposedly work.

If the natural market level for gas at the present time is 55% of crude oil, old interstate gas (under NGPA Sections 104 and 106(a)) would rise to $2.65 per MMBtu's; this would roughly double its 1982 price of about $1.30. To offset fully this price increase, all other gas -- including new and deep gas -- would have to fall to $2.65 per MMBtu's. For Section 102 new gas, this would mean a drop of $.70 -- or roughly 20% -- from the currently effective price ceiling of $3.35 per MMBtu's. Deep and tight sands gas would have to drop by roughly $4.00 -- or approximately 60% -- from its average price levels in late 1982.

It is simply unrealistic to expect producers to accept price declines of this magnitude, even if pipelines can brandish a "market out" clause. Resistance would be vigorous enough to forestall full attainment of the price declines needed. Further, pipelines could not hold prices for newly acquired gas to the required level unless they were willing to face an unacceptable decrease in drilling activity. It is one thing to reduce a producer's price to $2.65 when he has already made his investment in drilling and is already committed to keeping his gas flowing; it is quite another thing to expect that producer to undertake the high risks of new drilling for the same price.

Consequently, the theory will not work to the extent predicted and will boost average wellhead prices at a time when the industry can least afford it.

5. Even if we assume that the theory would indeed work as predicted, other major problems will arise. These include: a) placing pipelines in a "price squeeze" due to the failure of the PGA ceiling's inflation adjustment to account for unavoidable price increases from steady depletion of old gas volumes and the replacement of such production by volumes of newer, more expensive gas; b) a major bidding disadvantage for certain pipelines which, due to below average gas acquisition costs, are burdened by a smaller margin for price increase passthrough under the proposed PGA ceilings; c) at the same time, a particularly severe "price squeeze" for such pipelines due to disproportionately low PGA ceilings; d) creation of an artificial bidding advantage for intrastate pipelines; and e) erosion of long-term supply security, due to the achievement of a full offset through bringing new and deep gas prices down to a level which greatly reduces the incentive for new gas exploration efforts.

6. The only positive aspect of the Administration's approach to old gas decontrol is the fact that it would be evenhanded -- reaching even industrial users who have contracted directly with producers for inexpensive gas under direct purchase contracts. While sharp upward renegotiation of such contracts would greatly hinder the competitiveness of some companies, the alternative of exempting only those direct purchase contracts from old gas decontrol would: a) pose problems of equity; b) give directly purchasing companies a

major competitive edge over companies who would bear the burden of old gas decontrol in their utility bills; and c) preclude interstate pipelines from competing for these otherwise "marketed-out" gas supplies -- at a time when other provisions of the bill would be placing their supply security in jeopardy.

7. Mandatory pipeline transportation -- on behalf of a greatly expanded number of potential purchasers at the wellhead -- would force consumers of utility gas to run the risk of costs generated by underutilization of distribution system capacity. It would also be an administrative nightmare for both the gas industry and the FERC. Delay and confusion would be guaranteed by assigning to the FERC the responsibility for determining present and future pipeline capacity and for making a myriad of other decisions regarding efficient pipeline operation, the extent of a pipeline's obligation to serve all distribution company customers, and the pipeline's need to maintain high-priority, temperature-sensitive residential load through (among other things) operation of storage fields. Due to these and other factors, the proposed approach would cause inequities and might even result in higher gas prices for consumers.

8. For the above reasons, either A.G.A.'s own legislative principles -- or a greatly modified version of S. 615 -- would be far preferable to the Administration's approach.

SUMMARY OF KEY RECOMMENDATIONS

As we have noted, we may be offering a more specific assessment of S. 615 in the future. At the present time, however, we can provide these specific recommendations on S. 615's treatment of key issues:

1. Retain the proposed gas price "cap" -- but develop a better data base for it and keep it in effect permanently for escalator clauses in existing contracts which are never renegotiated.

2. Retain the proposed take-or-pay ceiling -- but reduce the ceiling from 70% of deliverability to 50% (with no option for the producer to sell untaken gas to a new purchaser). In addition: a) define "deliverability" (preferably as whatever definition is contained in the individual affected contract); b) allow makeup rights so that peak demand can be accommodated; and c) expand the exemptions to include an exemption for financial hardship of producers.

3. Retain the repeal of price control reimposition authority in NGPA Section 122.

4. Retain repeal of incremental pricing.

5. Retain repeal of mandatory Fuel Use Act restrictions on use of gas or oil.

6. Eliminate old gas decontrol and the related provisions which authorize old gas "market outs".

7. Eliminate the proposed PGA ceiling. In its place, substitute expansion of the NGPA's "fraud and abuse" standard to create a new, prospective standard -- for post-enactment contracts -- which allows passthrough of only "prudently incurred" costs.

8. If old gas decontrol and the proposed PGA ceiling are retained, some of the damage can be eased -- although hardly eliminated -- through the following actions:

    a. Expand the PGA ceiling's inflation adjustment to take into account the irreducible minimum of unavoidable price increases caused by depletion of inexpensive older gas over time.

    b. Modify the PGA ceiling to provide the additional passthrough margin needed by pipelines with above average supplies of relatively inexpensive gas and below average supplies of relatively expensive gas.

9. Eliminate proposed FERC authority to order mandatory pipeline transportation by a greatly expanded number of potential purchasers at the wellhead.

10. Establish an immediately effective 12-month "market out" authority for NGPA Section 107 gas (principally deep and tight).

In the discussion which follows, we will examine A.G.A.'s reasons for these specific recommendations.

ATTRACTIVE ASPECTS OF THE ADMINISTRATION BILL

Turning to specific aspects of S. 615, we stress that we are heartily encouraged by the attention that the Administration has paid to the gas contracts problem. We can remember when A.G.A. was virtually a voice in the wilderness in calling attention to the problem of indefinite escalators. Thus, we are heartened by the Administration's recognition that an orderly transition to wellhead decontrol must include legislative action to defuse indefinite escalator clauses and temporarily modify take-or-pay obligations.

In addition to this general comment, we also commend the Administration for five specific provisions of its bill.

Gas Price Cap

1. Section 301 would place a "cap" on the operation of contract escalator clauses; it would also reduce the level of NGPA price ceilings for new gas in those cases where the price ceilings exceed the "cap". We believe that the proposed restriction on escalator clauses is overdue and we also anticipate that, under current market conditions, the "cap" would lead to relatively immediate reductions in prices paid for NGPA Section 102 new gas. In addition, A.G.A. strongly supports the proposed approach of tying the "cap" to the weighted average cost of newly acquired gas (including gas covered by newly renegotiated contracts). We have previously

recommended adoption of this approach and we hold the view that the prices being paid for newly acquired gas -- rather than the prices being paid for oil or some other competing fuel -- constitute the best indicator of the true market value of gas at the wellhead.

Our only major reservation regarding Section 301 is the fact that the "cap" would expire on January 1, 1986. We recommend instead that the "cap" should apply to contracts until they are renegotiated -- even if such renegotiation does not occur until 1986 or later. In our view, the impact of an indefinite escalator clause is still negative -- even if the clause is in a contract that has somehow survived the renegotiation and "open season" period. In addition, the prospect of eventual removal of the "cap" may provide an incentive for some producers to "tough it out" -- through 1985 -- rather than participate in good faith renegotiation.

We do have two additional recommendations, of a technical nature, regarding the data base for the proposed "cap".

First, when a new well comes into production, the pipeline is required to estimate (for "cap" calculation purposes) the expected production levels for up to six months in the future. We recommend that shorter time frames be used for such projections in order to reduce the amount of highly speculative -- and potentially inaccurate -- information in the data base.

Second, it should be made clear that the "cap" price will not be published at all during those periods -- including the first few months after enactment -- when it is determined that the number of reported transactions is too small for an adequate data base. Under other provisions of the bill, the NGPA price ceilings would automatically apply during any periods when a "cap" is not published.

Take-or-Pay Obligations

2. Section 302 would -- for the period through 1985 -- authorize gas purchasers to reduce their minimum take-or-pay obligations to 70% of deliverability. We have stressed, in previous testimony, that we see a clear need for such a temporary take-or-pay ceiling. In the absence of such a temporary "ceiling", gas prices will continue to be artificially inflated as contractual obligations operate -- in some cases -- to require the displacement of relatively inexpensive gas in order to make room for minimum "takes" of relatively high-priced gas.

Nevertheless, despite our strong endorsement of the concept of a temporary take-or-pay ceiling, we doubt that a ceiling set at 70% of deliverability would provide sufficient price relief. That is, the minimum "takes" of relatively expensive gas would still be too high to permit optimum "takes" of relatively low cost gas.

In formulating our own recommendations in this area, we sought to reach a deliverability standard that would: a) permit a significant increase in the level of low cost gas production as a percentage of the total supply mix; without b) reducing minimum "take" levels so precipitously that the financial viability of gas producers would be threatened. In our view, the proper balance between these two concerns occurs at approximately 50% of deliverability.

We would add that the 70% of deliverability standard is too high to permit our industry to use minimum "take" reductions as a routine tool for contract renegotiation -- particularly since a pipeline is obligated to transport untaken gas for new purchasers. As an example, a producer selling gas at $6.00 per MMBtu's might make more revenue by selling 70% of his output at $6.00, and the rest at a lower price, than he could make by renegotiating all of his output to a new price of $4.00. A 50% ceiling -- while not precluding such economic calculations in every case -- would more frequently provide a "lever" for renegotiation.

Four other recommendations are also in order:

a) Producers should not be permitted to "market out" gas volumes which are untaken as a result of a pipeline's exercise of the new "take" reduction authority. In effect, the S. 615 approach would require pipelines to accept an unnecessary erosion of their reserves. Since some major pipeline financing arrangements provide for financial penalties if a pipeline's R/P ratio falls significantly, the fear of permanently losing untaken gas -- to another purchaser -- could effectively deter widespread use of the proposed authority to reduce "takes".

b) As a closely related point, the bill's omission of pipeline makeup rights should be corrected. That is, the bill is not flexible enough to permit pipelines to reduce "takes" during periods of low demand (for example, the summer months) and to make up the untaken gas during periods of peak demand (normally the winter months). This inability to vary "take" reductions -- for purposes of meeting peaks in gas demand --

would generally act as a strong deterrent to exercise of the "take" reduction authority.

c) In addition to the exclusion of casinghead natural gas and the discretionary authority to exempt gas from the ceiling on the basis of drainage problems, Section 302 should provide for an exemption -- by rule or order -- when and if the Federal Energy Regulatory Commission (FERC) determines that strict application of Section 302 would endanger the financial viability of a producer. Needless to say, expeditious procedures should be provided for the pursuit of such an exemption by producers.

d) "Deliverability" should be defined in Section 302. Otherwise, the existence of different deliverability definitions, in different contracts, could lead to unnecessary litigation. In this regard, the most administratively simple route would be a statutory statement that "deliverability" means whatever it means in each individual contract.

Repeal of Price Control Reimposition Authority

3. Section 203 would repeal Section 122 of the NGPA -- thereby removing the current authority for reimposition of price controls following new gas decontrol in 1985. We agree. As a trade association which has consistently supported decontrol of new gas, we support repeal of the NGPA's "standby" price control authority. The 1978 decision of Congress to initiate a phased shift to wellhead decontrol was a wise move, despite the transitional problems that have surfaced. Reversal of this course would erode the painfully attained supply

improvements of recent years, setting us back on the road toward a discredited era.

Repeal of Incremental Pricing

4. Section 503 would repeal incremental pricing -- as established under Title II of the NGPA. We agree. Most observers have long since recognized that this program artificially boosts gas prices for many industrial boiler owners -- thereby contributing to higher product prices and artificially hindering the ability of gas to compete with imported oil -- while simultaneously failing to achieve its intended objective of shielding residential and commercial consumers from gas price increases. Nevertheless, despite its discredited status, the program lumbers on; it may even gain a new lease on life if the Supreme Court -- in pending litigation -- decides that the House of Representatives violated the U.S. Constitution when it vetoed the FERC's Phase II incremental pricing proposal in 1980.

It is long past time to end the unsuccessful experiment with incremental pricing. Such action will lift an unnecessary burden from the shoulders of the gas industry, the industrial boiler owners, and those members of the FERC staff who must process reams of paper to administer a program that time has rendered virtually meaningless.

Repeal of FUA Restrictions

5. Section 501 would repeal the fuel use restrictions that are mandated by the Powerplant and Industrial Fuel Use Act (FUA). We strongly support such action.

Although Congress acted wisely in 1981 to eliminate the previous FUA restrictions on gas use by existing powerplants, the FUA still operates to impose an automatic ban on use of either gas or oil by large new industrial facilities and large new powerplants. Through this policy, the gas industry is literally "locked out" of opportunities for growth in key markets. Indeed, the industry is pushed toward eventual decline in these markets -- as existing large powerplants and industrial facilities are gradually retired and replaced by new facilities that are legally barred from using gas. The residential gas consumer will also be affected as this trend gains momentum -- since the FUA's mandatory preclusion of marketing opportunities will force the industry to allocate fixed system costs over a smaller base of volumes sold than might otherwise be the case.

OLD GAS DECONTROL AND THE PGA CEILING

Although we can point to several aspects of S. 615 which are attractive to A.G.A., the proposed decontrol of old gas and the proposed ceiling on pipeline PGA passthrough pose major obstacles to our support for this legislation. Because these two proposed policies would interact with each other to some extent in creating an adverse impact upon our industry and its customers, we will discuss these proposed policies jointly.

Incidentally, in our discussion we consistently refer to 1985 as the date set by S. 615 for old gas decontrol -- even though technically price controls would not be removed until 1986. As a practical matter, total decontrol would occur in 1985 because: a) at that time old gas producers would be free o withdraw from their contracts; and b) if this authority led to a renegotiated contract or a contract with a new purchaser, under other provisions of S. 615 decontrol would result immediately.

Theoretical Underpinnings of the Administration's Approach

Implicit in the Administration's approach is what some observers refer to as the "equilibrium" theory. At A.G.A. we refer to it more informally as the "seesaw" theory. We use this term because the theory literally envisions gas pricing as a seesaw: if (as a result of total decontrol) old gas prices rise substantially, new and deep gas prices will drop, and a balance will be reached at a relatively uniform price level.

The Administration's bill wisely recognizes that this result cannot possibly occur if rigid contractual restrictions prevent purchasers from bringing new and deep gas prices down as old gas prices begin to rise. Consequently, by proposing various renegotiation incentives before new gas decontrol and giving either party a unilateral right to dissolve contracts after new gas decontrol, S. 615 endeavors to "clear the system" of contractual distortions. Presumably, this permits the "seesaw" to operate with full efficiency -- in theory.

Unfortunately, we have doubts regarding whether the "seesaw" will work with full efficiency in practice. We agree that, if restrictions in contracts governing relatively expensive gas can indeed be "cleared from the system", new and deep gas prices will drop somewhat; indeed, where contractual provisions permit, purchasers are already acting to reduce these gas prices. The question is whether new and deep gas prices will be able to drop enough to offset fully the price increases unleashed by rapid decontrol of old gas.

If we are correct in our assessment that a full offset cannot be attained, then old gas decontrol in 1985 will generate a net increase in average prices at the wellhead. Needless to say, we do not look forward to such a net price increase at a time when we are already losing load to oil and grappling with strong consumer discontent.

Although the Administration bill implicitly reflects the theory that old gas price increases would be fully offset by declines in prices paid for new and deep gas, we do not believe that this theory would work with full efficiency in practice. Further, even to the extent that it did work, it would not work within the time limits necessary to permit an orderly transition to a deregulated market -- especially since the transition would be occurring during a time of critical competition in the volatile industrial markets.

When one attempts to apply the "seesaw" theory to the real world, the practical problems become evident. It is abundantly clear that, under total decontrol, producers will -- in most cases -- have the leverage needed to bargain old gas prices to a sharply higher price level. It is far from clear, however, that pipelines will have the leverage needed to negotiate the new and deep gas prices downward to the extent needed to avoid a net increase in average wellhead prices. For example, let us use 1982 price data (rather than speculative price projections for 1985), assume an oil price of $28.00 per barrel, and see how the theory would supposedly work.

If the natural market level for gas at the present time is 55% of crude oil, old interstate gas (under NGPA Sections 104 and 106(a)) would rise to $2.65 per MMBtu's; this would roughly double its 1982 price of about $1.30. To offset fully this price increase, all other gas -- including new and deep gas -- would have to fall to $2.65 per MMBtu's. For Section 102 new gas, this would mean a drop of $.70 -- or roughly 20% -- from the currently effective price ceiling of $3.35 per MMBtu's. Deep and tight sands gas would have to drop by roughly $4.00 -- or approximately 60% -- from its average price levels in late 1982.

It is simply unrealistic to expect producers to accept price declines of this magnitude, even if pipelines can brandish a "market out" clause. Resistance would be vigorous enough to forestall full attainment of the price declines needed. Further, pipelines could not hold prices for newly acquired gas to the required level unless they were willing to face an unacceptable decrease in drilling activity. It is one thing to reduce a producer's price to $2.65 when he has already made his investment in drilling and is already committed to keeping his gas flowing; it is quite another thing to expect that producer to undertake the high risks of new drilling for the same price.

Consequently, the theory will not work to the extent predicted and will boost average wellhead prices at a time when the industry can least afford it.

Thus, in 1985 as in 1982, two basic impediments will prevent the "seesaw" theory from working with full efficiency. First, producers will strongly resist price reductions of the magnitude required for a full offset. Second, the required reductions cannot be made in the price that would otherwise be available for gas produced from new drilling; since the costs of developing and producing newly acquired gas are inherently much higher than the costs incurred in developing and producing old gas, and since a higher price is also necessary to induce producer acceptance of the risks associated with new drilling, newly acquired gas has a much higher "threshold" price -- below which the necessary exploration and drilling levels cannot be sustained. As a result of these supply considerations, purchasers face inherent limitations on their ability to bargain new and deep gas prices downward without jeopardizing long-term supply security.

Negative Consequences Which Would Occur If the "Seesaw" Theory Does Not Work in Practice

For the reasons set forth above, we do not believe that the "seesaw" theory will work with full efficiency in practice. To the extent that the theory does not work in practice, S. 615 would generate a net increase in average prices at the wellhead.

Yet the proposed ceiling on interstate pipeline PGA passthrough is presumably premised on the assumption that, if interstate pipelines act prudently within the framework of S. 615, no net wellhead price increases -- above those attributable to inflation -- will occur prior to 1986. If interstate pipelines were given the renegotiation tools provided by S. 615 but spared the burden of handling old gas decontrol, this assumption might be largely valid. However, under circumstances which would virtually guarantee a doubling or tripling of old gas prices, we must greet this assumption with extreme skepticism.

To the extent that interstate pipelines are faced with net wellhead price increases that "overrun" the PGA ceiling, two possibilities materialize:

First, interstate pipelines could be forced to "eat" the "overrun". In this case, the financial viability of such pipelines could conceivably be endangered. (As an example of the possible impact, consider a hypothetical pipeline which has an "overrun" of only \$.10 per Mcf on a total annual volume of 1 Tcf. If these costs cannot be recovered, the pipeline would be forced to absorb a loss of \$100 million -- or \$.10 times 1 billion Mcf units -- plus possible carrying charges.) Even if insolvency is not a serious prospect, pipelines would be drained of the capitalization needed for the long-term supply development projects that future gas demand will require.

Second, interstate pipelines could successfully persuade the FERC to permit recovery of their "overruns". In this case, consumers would bear the brunt of price increases caused by old gas decontrol -- plus other boosts in their gas utility bills to the extent that gas price increases induce loss of industrial and powerplant load, which in turn requires fixed system costs to be allocated over a smaller base of volumes sold. At the same time, interstate pipelines would still face some financial injury -- because even the proposed "expedited"

FERC review of pipeline "overruns" would not permit early cost recovery, subject to refund, and would therefore require payment of costly carrying charges while FERC review is pending.

Neither of the above possibilities is very attractive. The most probable future, however, would be a "mix" of both possibilities: i.e., some pipeline recovery of "overruns" -- with a resulting negative impact on gas marketability and consumer budgets -- coupled with some erosion of the pipeline capitalization needed for long-term gas supply security. In this case, gas consumers would literally be paying more dollars for less gas.

Negative Consequences Which Would Occur Even If the "Seesaw" Theory Works in Practice

One measure of the difficulties posed by the Administration's approach is the long list of problems which would result even if the "seesaw" theory works perfectly. Assuming temporarily for the sake of argument that the old gas price boosts caused by decontrol would indeed be fully offset by price declines for new and deep gas, the serious problems set forth below would still arise. (Needless to say, some of these serious problems would be magnified if the "seesaw" theory does not work.)

1. The PGA ceiling inflation adjustment does not take unavoidable pre-1985 price increases into account. In 1985, the bill's "open season" for contract dissolution -- coupled with provisions allowing immediate decontrol when a contract is dissolved or renegotiated -- would effectively operate to

eliminate "vintaging" of wellhead prices. (By "vintaging", we mean the NGPA's assignment of different price ceilings to different gas categories on the basis of the well spud date and/or the contract date of the gas involved.)

Prior to 1985, however, "vintaging" would still exist; this means that two crucial factors must be considered. First, since the NGPA "vintaging" structure generally mandates price ceilings which decrease as one moves back in time to progressively older gas, newer gas tends to be more expensive than older gas. (This tendency would exist even in a free market, due to inherently higher costs of new gas development and production. However -- since the "seesaw" theory is blind to this factor -- we will, for the sake of argument, attribute all of the price differences to the NGPA.) Second, since inevitable declines in production of such older gas must be offset by volumes of newer production which is either subject to a higher price ceiling or deregulated completely, pipelines face an inexorable shift in the total supply mix -- which leads in turn to an irreducible minimum of unavoidable price increases at the wellhead. To put it another way, if all price ceilings were frozen in place tomorrow, average wellhead prices would still rise to some extent -- because those gas volumes which are subject to relatively high price ceilings would inevitably constitute a growing percentage of the total supply mix.

In this regard, we note the findings of a recent report by the General Accounting Office (GAO). (Natural Gas Price

Increases: A Preliminary Analysis, December 9, 1982.) On page 11 of the report, the GAO evaluates wellhead increases from 1981 and 1982 -- and highlights old gas depletion as a more important factor than automatic boosts in NGPA price ceilings:

> The total quantity increased by 2 percent. But the quantity of old (sections 104 and 106) gas contracted for in 1972 or earlier declined 15 percent, while the quantity of section 102 gas increased 18 percent and the quantity of high-cost (section 107) gas increased 70 percent . . .
>
> The increase in the average price, from $2.01 to $2.35 (adjusted for inflation), reflects both changes in proportionate quantities and changes in prices. To provide some perspective on the relative importance of prices and proportions, we compared the actual prices and quantities for 1981 with two alternatives. First, we calculated the average price of buying the 1981 volumes at the 1982 prices, to illustrate the importance of changes in price; the average price went from $2.01 to $2.10. Secondly, we calculated the average price of buying the 1982 volumes at the 1981 prices, to illustrate the importance of changes in proportions; the average price went from $2.01 to $2.22.
>
> The overall increase of $0.34 per Mcf may be compared with the 1981 quantities/1982 prices increase of $0.09 and the 1982 quantities/1981 prices increase of $0.21. The changes in proportionate quantities appear to account for about twice as much of the overall change as the price changes. (Emphasis supplied.) Even after the 7-percent inflation rate between the two periods is considered, the changes in proportionate quantities appear to account for at least half the overall change. (These results relate only to the two periods cited above and would not necessarily hold true for other periods.)

Thus, inevitable changes in the supply mix -- triggered by the unavoidable depletion of relatively inexpensive old gas -- are a major factor which no price relief legislation can wisely ignore.

If the "seesaw" theory is correct, price relief would arrive with the advent of an "open season" on gas contracts (and the theory's postulated elimination of "vintaging") in

1985. The PGA ceiling, however, would be in effect in 1983 and 1984: a period when pipelines would still be bound by existing contractual commitments and still affected by "vintaging". These forces would create more upward price pressure than the PGA ceiling's inflation adjustment could take into account. Consequently, pipelines would be "squeezed" between unavoidable price increases and a rigid limit on passthrough of their costs.

Although S. 615 does give pipelines some tools for reducing prices before 1985 -- notably the "cap" on wellhead prices and the authority to reduce minimum "takes" to 70% of deliverability -- we doubt that these tools are sufficient to avoid fully the "price squeeze" we have described. At the very least, the PGA ceiling's inflation adjustment should be expanded to include an additional adjustment for the effects of inevitable changes in the gas supply mix.

2. Following old gas decontrol in 1985, some pipelines would have insufficient volumes of new and deep gas to use for offset of the old gas price increases. If the "seesaw" theory will work at all, it will work on a national average basis: i.e., price reductions for the total volumes of new and deep gas production will balance price increases for the total volumes of old gas production. However, the distribution of these gas volumes is far from uniform as one moves from individual pipeline system to individual pipeline system. In some cases, pipelines have an above average percentage of new and deep gas in their supply mix and a below average percentage of old gas; in other cases, the reverse is true. In these

latter cases, a large portion of the pipeline's supply mix would rise rapidly in price -- but the pipeline would have little margin for offsetting these price increases because relatively expensive gas constitutes such a small portion of its supply mix. Barred by the PGA ceiling from pursuing automatic passthrough of major net increases in its costs of acquiring gas, such a pipeline would face a "price squeeze" of severe -- and possibly catastrophic -- proportions.

Placed in this situation, such a pipeline would have an unpalatable range of options. It could incur large "overruns" of the PGA ceiling and petition the FERC for approval, risking its financial viability if the petition is not successful and risking serious erosion of burner tip markets -- plus a severe consumer backlash -- if the petition is successful. It could also attempt to reduce the size of its "overruns": a) by acquiescing in producer withdrawal from some old gas contracts as an alternative to renegotiating old gas prices upward; b) by withdrawing from contracts for whatever relatively expensive gas it does have in its supply mix; or c) by pursuing a combination of these approaches. In this case, the pipeline's supply situation would deteriorate rapidly. Finally, the pipeline could pursue a "mixed" strategy of some "overruns" coupled with some cutbacks in gas supply.

Under any of these scenarios the pipeline would be forced to undercut either its customers' stake in supply security, or its customers' interest in reasonable prices, or both.

Ironically, despite the Administration's commitment to greater national reliance on market forces, the effects of the

PGA ceiling would send the message that efficiency in the marketplace will be penalized. That is to say, the burden of the PGA ceiling would fall most heavily upon those pipelines which have been most successful in building their supply security on the least expensive gas sources available.

Contrary to the speculation of some observers, a pipeline does not attain a relatively low cost supply mix by accident. Dice were never tossed to determine which pipelines would enjoy a relatively large percentage of comparatively inexpensive gas. Although some portion of a pipeline's position may be due its supply and service territory, more than random factors were at work. It may be easy to attain a relatively low cost supply mix by bidding inadequate prices at the wellhead -- if a pipeline is willing to risk the supply security of its customers -- but it is a major advantage to attain both a low average gas cost and a secure supply posture.

It would be a tragic irony indeed if the perversities of regulation transformed a normally enviable position into a precarious liability. The message sent by such a development would discourage marketplace efficiency throughout the industry.

We are aware that S. 615 attempts to avoid this situation by allowing a slightly higher inflation adjustment for pipelines with low average gas costs. Nevertheless, the margin of relief provided is not enough. It is not nearly enough. At a minimum, the PGA ceiling must be made flexible enough to accommodate the situation of pipelines with a relatively low cost supply mix. The best solution, however, would be a decision by Congress to reject old gas decontrol and the proposed PGA ceiling.

For further information on this point, we have attached a document -- prepared by one of our member companies -- which analyzes the impact of the proposed PGA ceiling on two hypothetical pipelines.

3. Intrastate pipelines would enjoy a major, artificially created bidding advantage. Although the PGA ceiling would be mercifully limited to the period until 1986, until it expires the PGA ceiling would confer an artificial bidding advantage upon intrastate pipelines (which would not be subject to the PGA ceiling). This freedom from the pressures generated by PGA ceilings, coupled with the proposed expansion of intrastate access to out-of-State gas and a natural edge in bidding for home State gas (due to lower transportation cost "add ons"), could give intrastate pipelines a major advantage in acquiring new gas supplies. While we support expanded intrastate pipeline access to certain gas sources (i.e., OCS gas, imported gas, and surplus interstate pipeline gas), we do not wish to risk a repetition of the bidding imbalances that magnified the severity of gas shortages in the mid-1970's.

4. Long-term supply security would be significantly eroded. As we have indicated at previous points in our testimony, price boosts triggered by old gas decontrol would be so large that it is doubtful that new and deep gas price reductions can fully offset the price impact. However, if the "seesaw" theory is correct and a full offset could be attained, it could only be attained at the cost of eroding long-term gas

supply security. That is, the requisite price reductions for new and deep gas would be so large that they would necessarily depress levels of exploration and drilling for new gas supplies (and might even pose the risk of inducing producers to "shut in" some existing production). This adverse impact on long-term supply security would be compounded by the effect of the PGA ceiling, which would tend to shrink the pipeline capitalization available for important long-term supply development projects.

DOE's own Economic Analysis confirms our basic viewpoint by projecting that, during the remainder of this decade, the Administration proposal will result in gas production that is 510 Bcf below the level projected if the NGPA is retained. We strongly suspect that the DOE's estimate of the negative impact on supply is too conservative -- but at least DOE acknowledges that a net negative impact will occur if S. 615 is enacted in its present form.

(Incidentally, DOE's Economic Analysis compared current law with the Administration proposal and found that the Administration proposal provided greater supply at lower prices in the near term and less supply, at higher prices, after 1985. We would suggest that all the benefits found by DOE are due to capping indefinite escalator clauses and reducing take or pay levels, while the detriments of higher prices and lower supply -- in the second half of the decade -- are due to old gas decontrol. We recommend that the Senate request DOE to prepare an analysis, using identical assumptions and methodology, of the impacts of contract clause restrictions without old gas decontrol. We believe such an analysis would show dramatic price relief without impairing supply.)

Even though A.G.A. has traditionally been optimistic on the gas supply outlook, our optimism has always been premised on the ability of gas purchasers to pay adequate prices -- and invest adequate capital -- for development and production of new gas supplies. S. 615, as presently structured, would greatly erode this ability -- even if, or perhaps especially if, the "seesaw" theory works. We frankly fail to understand why it would be wise to jeopardize incentives for future gas supplies in order to provide major price increases for old gas that is clearly producible at present price levels.

The Pipeline Accountability Alternative

We believe that, as an alternative to the inequities and rigidities of the proposed PGA ceiling, the present PGA passthrough standards of "fraud and abuse", as contained in the NGPA, should be strengthened to include a prudence standard for post-enactment contracts.

COMMON CARRIAGE PIPELINE TRANSPORTATION

S. 615 would also make major changes in gas transportation. Mandatory pipeline transportation -- a concept that we approach with great caution -- appears three places in the bill:

- If the buyer rolls back takes to 70%, the producer is entitled to carriage for the gas refused;
- If either party exercises a market out, the producer is entitled to carriage for such gas; and
- If any party petitions FERC, the Commission may order an interstate pipeline to transport gas, as long as the pipeline has capacity.

The terms for carriage are the same in each case: $.05 per MMBtu's plus the costs of transportation unless FERC sets a different rate. The $.05 goes to the pipeline's shareholders. The problem here is that the FERC seems to have the power under the "unless" clause to issue a generic rule on transportation that is less remunerative than the $.05 per MMBtu's incentive rate, so that the shareholders' benefit could evaporate. If the FERC's incentive rate is more than $.05 per MMBtu's, the excess would probably be flowed through to the pipeline's customers.

The new mandatory transportation provisions cannot be appreciated until they are read with the changes to NGPA Sections 311 and 312. The bill amends those NGPA sections so that direct users, distributors, and intrastate pipelines may all buy gas in the interstate market. This significant change would allow a wide range of potential purchasers in one State to buy gas in another State, the OCS or even a foreign country -- and have it transported to its home State by an interstate pipeline, all without becoming subject to Federal jurisdiction. This provision brings literally hundreds of unregulated buyers into the interstate gas market just when interstate pipelines would be greatly hindered in bidding for supplies because of the passthrough limit. Once again, interstates might be unable to compete for gas supplies, perhaps leading to a repeat performance of the pre-NGPA shortages of 1977.

Natural gas pipelines have never been common carriers, although they do carry gas for others on a contract basis. The difference between the two is that common carriage is transportation on demand -- i.e., it is mandatory -- while contract carriage is by agreement of the parties.

This difference between mandatory and voluntary carriage is crucial for a regulated industry. Natural gas pipelines cannot add new capacity at will; the FERC scrutinizes applications for new pipelines very carefully to ensure that the applicant is not inflating the ratebase by overbuilding. Furthermore, overcapacity and underused pipeline are a drain on the ratepayers. Thus, mandatory carriage is a severe imposition on a pipeline's ratepayers, who have to bear the risk of major expenses incurred through overbuilding or underutilization. We would argue that mandatory common carriage is therefore seldom appropriate for a regulated natural gas pipeline.

The Administration's bill implicitly recognizes the inherent infirmities of mandatory common carriage and tries to avoid them by calling its requirements "contract carriage". This may be distinction without a difference. The key to the Administration's proposal, as far as we are concerned, is that contract carriage would be available upon application of any party to the FERC. Although the Commission could not order new capacity and would be required to consider the needs of the interstate pipeline's customers and the extent of available excess capacity before ordering carriage, we do not think that the proposed FERC procedure is going to work. The FERC would be forced to make pipeline capacity decisions for all interstate transmission companies as hundreds of end-users and distribution companies requested carriage. Each pipeline is characterized by different capacity considerations, seasonal factors, storage capacity, and other operational considerations.

This administrative morass is unnecessary -- because interstates can and do transport gas for others today. We are convinced that, if an incentive rates of $.05 per MMBtu's is indeed established and if the FERC could only move higher than -- but not lower than -- this rate, such voluntary incentives alone would encourage third party transportation in those cases where available capacity and low risks of underutilization make such transactions in the public interest.

We are aware of the view of some that common carriage would reduce average wellhead prices by permitting more purchasers to "shop around" for the least expensive producer available. However, we urge this Committee to remember that "shopping around" works both ways. The producer can "shop around" also -- and, with hundreds instead of dozens of potential purchasers competing with each other in bidding at the wellhead, the price might well be bid upward rather than downward. In any event, even if we grant the debatable assumption that wellhead prices would decline, residential and commercial gas consumers -- who would still be relying on the gas utility system -- might face increased operational costs due to: a) possible underutilization of pipeline capacity; and b) reallocation of fixed system costs as industrial users withdraw from the utility system to become direct purchasers.

We also note that the trend of transportation regulation (in industries such as air travel, trucking, and railroads) has been away from common carriage and governmental second-guessing -- and toward more flexible, voluntarily negotiated agreements.

OTHER PROVISIONS OF S. 615

Although we are still in the process of evaluating the numerous provisions of S. 615, we can offer some preliminary observations on certain provisions.

1. For the same reasons that we oppose rapid decontrol of old gas, we oppose the policy of permitting producers to withdraw from old gas contracts. We believe that the contract withdrawal option should focus on those contracts which are causing the most severe current problems for gas consumers: i.e., contracts governing NGPA Section 107 gas.

2. In the case of deep gas and other Section 107 gas, S. 615 attempts to deal with current problems by effectively "freezing" prices at current levels until the "open season" begins in 1985. While this policy would prevent current problems from growing worse, it would not affirmatively provide price relief. Consequently, we recommend the alternative of initiating an immediate, 12-month "open season" for contracts governing NGPA Section 107 gas.

3. As noted above, we believe that "market outs" should be limited to contracts governing NGPA Section 107 gas. Regardless of the scope of these "market outs", however, we strongly oppose one aspect of Section 303. The new NGPA Section 316(d)(1) provides that "In the event that a contract is terminated . . . a pipeline that was a party to the terminated contract shall have an obligation to transport natural gas for a producer that was a party to the terminated contract." This language appears to establish a pipeline transportation obligation even when it is the producer who withdraws from the contract. In light of the protection

provided for existing pipeline customers by the new NGPA Section 316(d)(2) and the $.05 per MMBtu's of compensation for transportation, we are willing to accept a transportation obligation when the pipeline withdraws from a contract or reduces its minimum "take" to 70% of deliverability. However, we consider it unfair to hold pipelines responsible for the consequences of a producer's decision to withdraw from a contract.

Incidentally, the language cited above may conceivably be a simple drafting error -- since the Administration's Section-by-Section analysis of its bill states, in the discussion of Section 303, that the new NGPA Section 316(d) "would require a terminating pipeline to transport a volume of gas. . ." (Emphasis supplied.)

4. We are still in the process of assessing the full impact of the intrastate pipeline access provisions of S. 615. Nevertheless, we can note at this time that A.G.A. supports expanded gas access for intrastate pipelines to the extent that: a) non-jurisdictional access to imported gas and Outer Continental Shelf gas is provided; b) a "reverse §311(b)" -- permitting intrastate pipelines to enter into 2-year contracts for surplus interstate pipeline gas -- is established; and c) the gas acquisition transactions themselves, while not making the intrastate pipeline system subject to FERC jurisdiction, occur under regulatory conditions that are comparable to conditions faced by interstate pipelines.

CONCLUSION

As we have stressed previously, we are still evaluating S. 615 -- and we will undoubtedly be back to you in the future with additional details.

Nevertheless, as our testimony makes clear, we can offer a general assessment of S. 615. It has served as a starting point for debate and for prompt deliberations by this Committee; thus, we commend Secretary Hodel and the Administration for providing this momentum. Also, it offers reasonable provisions which can reduce prices paid for new and deep gas _without_ jeopardizing long-term supply security. Unfortunately, these price relief provisions are accompanied by old gas decontrol -- which will more than wipe out the price reductions that S. 615 would otherwise provide. Further, while forcing our industry to pay higher average prices at the wellhead, the bill imposes a rigid PGA ceiling that would gravely impair the ability of pipelines to handle this upward price pressure. Finally, the bill contains pipeline common carriage transportation provisions which -- if enacted -- could lead to adverse and presumably unintended consequences.

We strongly recommend legislation that focuses on price relief and avoids the thorny thicket of either old gas decontrol or measures to restructure the gas industry. Either a greatly modified version of S. 615, or A.G.A.'s own legislative principles, would be far preferable to the current version of the Administration's bill.

Thank you for this opportunity to testify. I will be pleased to answer whatever questions you may have.

A Calculation to Illustrate the Effect on the Purchasing Ability of Two Different Pipeline Companies

This example illustrates the discriminating effect on the purchasing ability of a "low cost" pipeline vs. a "high cost" pipeline to replace dwindling gas supplies. As shown below, Pipeline B (high cost) has the advantage over Pipeline A (low cost) since Pipeline B can bid up to $6.03/MMBtu and Pipeline A can only bid up to $3.06/MMBtu for replacement of dwindling old gas supplies while both pipelines would be allowed under S. 615 to passthrough these gas purchase costs to their distribution customers.

Prior to Adjustment

Pipeline A High Percentage of Old Gas Low Average Gas Cost			Pipeline B Low Percentage of Old Gas High Average Gas Cost		
Cost Type	Volume Bcf	Average Price $/MMBtu	Cost Type	Volume Bcf	Average Price $/MMBtu
Old	500	$2.23	Old	110	$2.23
New	110	3.30	New	393	3.30
High	23	4.94	High	130	7.00
Total	633	$2.51	Total	633	$3.87

After Price Adjustment and Replacement of 10% of Old Gas

Pipeline A			Pipeline B		
Cost Type	Volume Bcf	Average Price $/MMBtu	Cost Type	Volume Bcf	Average Price $/MMBtu
Old	450	$2.23	Old	99	$2.23
New	110	3.30	New	393	3.30
High	23	4.94	High	130	7.00
Replacement	50	3.06	Replacement	11	6.03
Total	633	$2.58	Total	633	$3.94

Assumptions:

1) Monthly Inflation Rate (FERC Order) = .00367
(This equates to an annual inflation rate = 4.404%.)
2) Average National gas purchase rate = $3.00/MMBtu.
3) Each pipeline needs to replace 10% of its dwindling gas supplies in six (6) months.
4) Each pipeline has constant and equal sales requirements.
5) One(1) Mcf = One(1) MMBtu.
6) Since pipeline companies generally file purchase gas costs adjustments every six (6) months, the allowed incremental rate would increase a pipeline's prior purchase gas costs by $(.00367)^6$($3.00) = 7¢/MMBtu.

ENERGY ANALYSIS

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1983-3 March 4, 1983

COST COMPONENTS OF THE AVERAGE GAS PRICE

Digest

Retail gas prices increased an average of 18% per year between 1971 and 1981. While prices to end users have been increasing, the percentage of the customer's dollar within the control of the regulated gas industry has steadily declined.

Purchased gas costs (wellhead and supplemental gas prices plus gathering costs) accounted for 60% of the retail price of gas in 1981, compared to 32% in 1971. Over the same period, net operating income as a percentage of total revenues decreased from 14% to 4% for transmission companies and from 11% to 5% for distribution companies. Overall, costs under the control of gas distribution companies (all costs other than purchased gas costs and taxes) increased at an average of 5.7% per year -- almost two percentage points slower than inflation.

In addition to sharply higher purchased gas costs, the gas industry also faced rapidly increasing tax costs. The regulated gas industry has a significantly higher tax burden than the average for all U.S. industries -- with federal, state and local taxes representing 95% of net income for the gas industry versus 60% of net income for the average of all industries. Taxes have a major influence on gas prices. Overall, 29% ($1.17 per Mcf) of the consumer's 1981 national average gas price of $3.98 is attributable to federal, state and local taxes.

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COST COMPONENTS OF THE AVERAGE GAS PRICE

A. Background

The retail price of natural gas includes costs which flow through the gas industry from producers to transmission and distribution companies to the final customer. Two of these components -- the commodity cost of gas, and taxes -- are of particular interest today because of potential legislative action in these areas.

The purpose of this paper is to analyze the changes in gas production, transmission and distribution sector costs between 1971 and 1981, and discuss how these changes have affected the average retail price of gas. The paper also examines the total tax burden of the gas industry.

B. Executive Summary

The majority of the increases in utility retail gas prices over the past decade have been due to factors beyond the control of the regulated gas utility industry:

- Sixty percent of the average retail gas price can be attributed to purchased gas costs (wellhead and supplemental gas prices plus gathering costs) in 1981, compared with 32% in 1971.
- Costs under the control of the regulated gas industry, such as operating and maintenance costs, including transmission, distribution, and storage costs, and administrative costs, depreciation and net operating income, have declined as a percentage of the average gas price, from 49% in 1971 to 28% in 1981.
    - For gas transmission companies, net operating income decreased from 14% of total revenues in 1971 to 4% in 1981.
    - Net operating income for distribution companies declined from 11% of revenues in 1971 to 5% in 1981.
- Overall, 29% or $1.17 of the consumer's 1981 national average gas price of $3.98 is attributable to federal,

state and local taxes, with some consumers paying well above this average figure (see Table 1).

- Almost eighty percent of the tax burden falls on gas producers, transmission and distribution companies; while an additional 20% ($0.24/Mcf) above the retail gas price of $3.74 is attributable to state and local add-on sales taxes paid by consumers.

- The tax burden on the natural gas transmission and distribution industry is significantly higher than the average for all industries, and higher than most manufacturing industries. In 1979 (the latest year data are available for all industries), federal, state and local taxes for the gas transmission and distribution industry were equal to 95% of net income -- compared to the average of 60% for all industries.

C. Discussion of Results

Transmission and Distribution Company Costs

The retail gas price reflects not only the purchased cost of gas, but also the amount transmission and distribution companies must add to cover their costs of doing business. These costs include transmission and distribution, storage and administration, also known as operating and maintenance costs; depreciation; taxes; and net operating income.

Gas prices have been increasing to all classes of customers over the past decade. Between 1971 and 1981, the U.S. average cost of gas to residential customers increased 14% per year and to industrial customers 23% per year (including inflation). However, while prices to end users have been increasing, the percentage of the gas consumer's dollars within the control of the gas distribution and transmission industry has steadily declined.

As the example of the allocation of transmission company revenues shown in Table 2 illustrates, the percentage of total transmission company revenues which were used to pay for purchased gas increased from 60% in 1971 to 80% in 1981. The cost of gas to pipelines includes the wellhead price of gas plus gathering costs, taxes, and supplemental supplies. Wellhead gas prices have increased as old, inexpensive gas supplies were being depleted and replaced by new, more expensive supplies, and because of increased ceiling prices for gas allowed under the Natural Gas Policy Act of 1978. The increase in gas exploration and production costs has also had an impact on wellhead gas costs. For example, between 1971 and 1981, average drilling costs for gas wells rose from $27 per foot to $122 per foot, or an average annual increase of 16% per year.[1]

Table 1

THE IMPACT OF TAXES ON RETAIL GAS PRICES

	Cost Components of Retail Gas Price Per Mcf	Tax Portion Per Mcf	Taxes as Percentage of Cost Components
Production	$2.24	$0.57	25%
Transmission & distribution	1.50	0.36[1]	24%
Sales Tax	0.24	0.24	100%
Retail Price	$3.98	$1.17	30%

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[1] Reflects the average tax per Mcf on all flowing gas including regulated utility sales as well as direct sales.

Table 2

ALLOCATION OF OPERATING REVENUES FOR TRANSMISSION COMPANIES[1]
1971 AND 1981

(millions of current dollars)

	1971		1981		Compound Annual
	dollars	%	dollars	%	Growth Rate
Purchased Gas Costs[2]	4,140	60	40,963	80	26
Transmission, Distribution and Storage	517	7	3,339	7	21
Administration	209	3	1,031	2	17
Depreciation	572	8	1,466	3	10
Taxes	532	8	1,847	4	13
Net Operating Income	985	14	2,221	4	8
Total Operating Revenues	6,955	100	50,867	100	22

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1. Excludes data for integrated companies (i.e., companies with both distribution and transmission components).

2. Includes severance taxes paid as part of purchased gas price.

Source: Gas Facts: 1981 and 1971 edition (Arlington, VA: American Gas Association).

Table 3

ALLOCATION OF OPERATING REVENUES FOR GAS DISTRIBUTION COMPANIES[1]
1971 and 1981

(millions of current dollars)

	1971		1981		Compound Annual
	dollars	%	dollars	%	Growth Rate
Purchased Gas Costs[2]	2,879	51	13,341	74	17
Transmission, Distribution and Storage	502	9	902	5	6
Administration	641	11	1,291	7	7
Depreciation	273	5	426	2	5
Taxes	700	13	1,280	7	6
Net Operating Income	610	11	910	5	4
Total Operating Revenues	5,605	100	18,150	100	12

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1. Includes gas distribution operations of combination companies. Excludes data for integrated companies (i.e., companies with both distribution and transmission components).

2. Does not include gas purchased by companies other than distribution and combination companies, i.e., does not include direct sales, sales to integrated companies, and sales to municipals.

Source: Gas Facts: 1981 and 1971 edition (Arlington, VA, American Gas Association).

Operating and maintenance charges have stayed constant as a percentage of total revenues, even though this category includes pipeline fuel and storage gas costs which are directly determined by purchased gas costs. Administrative costs, which include salaries and marketing costs, decreased from 3% of revenues in 1971 to 2% of revenues in 1981. Most notably, net operating income for transmission companies decreased from 14% of total revenues in 1971 to 4% in 1981. Depreciation cost, which is a function of long-term fixed investment, also decreased as a percentage of total revenues from 8% in 1971 to 3% in 1981.

For distribution companies, the percentage of total revenues used to purchase gas increased from 51% in 1971 to 74% in 1981 as shown in Table 3. Storage and operating costs decreased as a percentage of revenues, as did administrative costs. Net operating income declined from 11% of revenues in 1971 to 5% in 1981. During the 1971 to 1981 period, net operating income of gas distribution companies increased at 4% per year -- 3 percentage points slower than the average inflation rate of 7.4% per year. Overall, those costs under the control of gas distribution companies (all costs other than purchased gas costs and taxes) increased at 5.7% per year -- almost 2 percentage points slower than inflation.

A comparison of the percentages shown in Tables 2 and 3 indicates that gas costs have increased at a greater rate to pipelines than distributors -- 26% per year versus 17% per year. This is because the rate of increase for pipeline costs, other than purchase gas costs, was significantly lower than the increase in wellhead prices.

The allocation of revenues and costs to customer categories for ratemaking purposes varies by utility. Therefore, the average cost of gas to all gas utility customers in 1971 and 1981 was used to illustrate the cost components of the retail gas price. As shown in Table 4, the commodity cost was about 60% of the average retail price of gas in 1981, compared with 32% in 1971. A total of 12% of the average retail gas price was for transmission and distribution industry taxes, including severance taxes. Severance taxes are levied on gas produced within a state and are normally paid by the purchaser as part of the cost of gas, unless the contract states otherwise. Of the costs in the control of gas distribution and transmission companies, 17% of the average retail gas price in 1981 went to operating and maintenance costs, 4% to depreciation, and 7% to net operating income. About 28% of the average retail gas price is controllable by the regulated gas industry, compared with 49% in 1971.

The data in Table 4 illustrate how gas industry taxes have increased, although taxes took a smaller percentage of total revenues in 1981 than they did in 1971.

Table 4

REGULATED GAS INDUSTRY EXPENSES AS A PERCENTAGE OF RETAIL GAS PRICE 1971 and 1981

	1971 $/Mcf	%	1981 $/Mcf	%	Compound Annual Growth Rate
Cost of gas (excluding severance taxes)	$0.22	32	$2.24	60	26
Operating and maintanence[1]	0.16	23	0.62	17	15
Depreciation	0.06	9	0.15	4	10
Taxes (including severance taxes)[2]	0.13	19	0.45	12	13
Net Operating Income	0.12	17	0.28	7	9
Average Retail Price	$0.69	100	$3.74	100	18

Note: This breakdown excludes all taxes paid by producing companies, and state and local sales taxes.

1. Includes transmission, distribution, storage and administration costs.

2. Reflects average tax per Mcf on gas flowing through the regulated utility industry, excluding direct sales which do not flow through the distribution segment and therefore would not be taxed at the distribution level.

Taxes

There are four major types of taxes for the gas industry. These are: (1) federal and state corporate income taxes accrued by producers, pipelines and utility companies; (2) state severance taxes on gas produced; (3) various forms of state utility taxes, including gross receipts taxes, property taxes and taxes on pipeline operations within a state; and (4) state and local sales taxes.

As shown in Tables 5 and 6, federal income taxes account for the majority of the taxes accrued by transmission companies, while state and local taxes account for the majority of taxes accrued by the distribution segment. According to the State Tax Handbook,[2] over half of all states levy some form of tax on gas utilities and/or pipelines operating within the state (in addition to corporate income taxes).

Although taxes are paid by all businesses, the tax burden on the natural gas transmission and distribution industry is significantly higher than the average for all industries, and higher than most manufacturing industries. This is particularly evident for state and local taxes. Table 7 shows a comparison of state, local, and federal income taxes as a percentage of net income in 1979 (the latest year data are available from the Internal Revenue Service) for all industries, for selected manufacturing industries and for gas and electric companies. State and local taxes represented an average of 63% of net income for gas transmission and distribution companies -- compared to 40% for all industries, and federal taxes represented an average of 31% of net income -- compared to 20% for all industries.

There are additional taxes which impact the price of gas, but are not included in the data shown in Tables 5 and 6. Severance taxes on natural gas production are often levied by state governments. This tax is actually included in the purchase gas cost to the pipeline and is passed on to the consumer. In 1981, severance taxes added about six percent to the cost of gas to the pipeline. This estimate is based on severance tax rates from 18 producing states.

State, local and city sales taxes also have a significant impact on the end-use price of gas. State sales taxes on gas are very common. These taxes are normally paid by the consumer and do not apper as utility company revenues. In 1980, according to a national tax survey compiled by the Mississippi State Tax Commission, 18 states had a sales tax on residential gas with an (unweighted) average rate of 3.4%, and 19 states had a sales tax on industrial gas, with an (unweighted) average rate of 3.4%.[3]

Table 5

Federal and State Taxes Accrued by Transmission Companies[1] 1971 and 1981 (millions of dollars)

	1971	%	1981	%	Compound Annual Growth Rate
Federal Income	316	60	1,275	69	15
Other Federal	12	2	100	5	24
State Income	23	4	106	6	17
Other State & Local[2]	181	34	366	20	7
Total	532	100	1,847	100	13

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1. Excludes data for integrated companies.

2. Excludes severance taxes.

Source: Gas Facts: 1981 and 1971 edition (Arlington, VA: American Gas Association.

Table 6

Federal and State Taxes Accrued by Distribution Companies[1] 1971 and 1981 (millions of dollars)

	1971	%	1981	%	Compound Annual Growth Rate
Federal Income	209	30	265	21	2
Other Federal	27	4	76	6	11
State Income	16	2	30	2	6
Other State & Local	448	64	909	71	7
Total	700	100	1,280	100	6

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1. Excludes data for integrated companies, and includes gas distribution operations of combination companies.

Source: Gas Facts: 1981 and 1971 edition (Arlington, VA: American Gas Association).

Table 7

FEDERAL AND STATE TAXES AS A PERCENTAGE OF NET INCOME FOR SELECTED INDUSTRIES -- 1979

(millions of current dollars)

Industry	Net Income	State and Local Taxes[1]	%	Federal Income Tax[2]	%	Total Federal, State & Local As % of Net Income
Electric Services	$ 2,357	$ 3,588	152	$ 386	16	169
Gas Transmission and Distribution[3]	3,454	2,195	63	1,082	31	95
Selected Manufacturing Industries						
Food	9,099	5,518	61	2,751	30	91
Textiles	1,874	996	53	655	35	88
Rubber	1,915	1,131	59	516	27	86
Primary Metals	5,898	3,011	51	1,526	26	77
Stone, Clay, Glass	3,044	1,257	41	858	28	69
Fabricated Metals	7,242	2,726	38	2,179	30	68
Lumber	3,596	1,307	36	770	21	58
Paper	4,753	1,309	28	1,270	27	54
Petroleum & Coal Refining	33,170	12,097	36	5,747	17	54
Chemicals	13,976	3,108	22	3,308	24	46
All Industries[4]	321,650	127,752	40	65,888	20	60

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1. Includes all state and local taxes, social security, payroll and unemployment taxes, import and tariff duties, and business, license and privilege taxes.

2. Federal income tax, after application of foreign tax credit, investment credit, and jobs credit.

3. State and local taxes are assumed to exclude severance taxes.

4. Includes agriculture, forestry, and fishing; mining; manufacturing; transportation and public utilities; wholesale and retail trade; finance, insurance and real estate; services.

Source: Statistics of Income -- Corporation Income Tax Returns, 1978-1979 (Washington, DC: Internal Revenue Service), May 1982.

Local and city governments also levy taxes on gas companies. Because there are over 15,000 local assessing districts, nationwide data on municipal taxes on gas are not available. An examination of specific cases for several A.G.A. member companies indicates that local taxes can range from a 1% "franchise" fee to an 8.9% municipal tax. As these taxes are levied on the dollar value of the gas bill, they can increase proportionately as gas prices increase. A.G.A. has estimated state, local and city sales taxes increased the retail cost of gas, on average, by about 7% in 1981.

Table 8 summarizes the impact of all forms of taxes on the average retail gas price. Gas producers, transmission and distribution companies, and consumers paid a total of over $22 billion dollars in taxes in 1981. This is roughly $1.17 per Mcf, or 29% of the 1981 national average retail price of gas, including state and local sales taxes.

D. Methodology and Data Sources

Because tax rates are complex and change constantly, this study does not attempt to derive precise tax revenues, nor represent the financial or tax profile for any individual company or region.

Much of the information in this analysis is based on company financial reports. Data illustrating the allocation of operating revenues in Tables 2 and 3, and data on taxes accrued shown in Tables 5 and 6 were taken directly from the A.G.A. statistical yearbook, Gas Facts.[4] Because it is difficult to allocate the costs of integrated companies (i.e., companies with both transmission and distribution components) between the two segments, revenues for integrated companies were not included in the examples of gas industry cost components shown in Tables 2,3,5 and 6. However, data for integrated companies was included when the tax burden on the total gas industry was estimated (see Tables 1,4,7 and 8). Information on taxes for selected industries was taken from the publication Corporate Income Tax Returns compiled by the Internal Revenue Service.[5]

By evaluating the available information from several sources, it was possible to estimate how transmission and distribution company expenses affect the retail price of gas, and, in particular, how gas industry taxes affect the retail price of gas. The methodology for deriving these estimates is discussed below.

- Cost components for the retail gas price (see Table 4) were derived by (1) applying the percentage of transmission company revenues used to purchase gas to the city gate price to obtain the cost of gas to the pipelines (the city gate price is defined as the distribution company's average acquisition cost of gas per Mcf from the transmission company); (2) applying the

Table 8

ESTIMATED TOTAL TAXES
NATURAL GAS INDUSTRY -- 1981
(millions of dollars)

Industry		Tax
Producers	Federal	8703.0[1]
	State & Local	514.0[1,2]
	Other Federal	1711.0[3]
Transmission & Distribution	Federal	2504.0[4]
	State & Local	2566.0[4]
	Severance	1856.0[5]
Consumers	State & Local	4700.0[6]
		22554.0
1981 Gas Sales (Bcf)		19297.0[7]
Tax per Mcf		1.17/Mcf
Average retail gas price		3.98/Mcf[8]
Taxes as a percent of retail gas price		29%

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1. Federal income taxes (excluding foreign tax credit) and state and local taxes paid as a percentage of 1979 business receipts from the production of oil, gas and natural gas liquids, applied to the 1981 marketed production value of gas.

2. Excludes severance taxes.

3. Other Federal taxes were assumed to cover Federal royalty payments on gas produced from offshore Federal lands. Source: United States Geological Survey.

4. Taxes for total transmission and distribution industry, including integrated and gas operations of combination companies. Source: Gas Facts: 1981.

5. Estimate based on severance tax rate for 18 producing states as a percentage of 1981 marketed production value.

6. Estimate based on a survey of residential gas rates from 37 companies. Residential sales tax rate was assumed to be representative of state and local taxes for all gas distribution companies for all sectors (residential, commercial, industrial). Weighted average tax rate of 7% was applied to 1981 value of gas delivered to all consumers of $62.5 billion (source: Natural Gas Annual).

7. Source: Gas Requirements Committee. Excludes field use gas.

8. Includes $3.74/Mcf retail gas price plus $0.24 state and local sales taxes.

percentage of transmission company revenues used for other costs (e.g., operating and maintenance, depreciation, taxes, and net operating income) to the city gate price; (3) applying the percentage of distribution company revenues used for costs other than purchased gas to the retail gas price; and (4) adding the transmission and distribution company costs together to obtain a break-out of the retail gas price which includes the cost of gas, as well as costs added by the transmission and distribution segments of the gas industry, i.e., operating and maintenance costs for both transmission and distribution companies, depreciation for both segments, taxes for both segments, and the portion of the bill which represents net operating income for both segments of the gas industry.

As shown in Table 4, about 12% of the retail gas price represents taxes accrued by the transmission and distribution segments of the gas industry on gas sold through the utility system. However, the total tax bill for gas is greater. Producers and consumers also pay taxes on gas. To estimate the total tax burden, taxes on producers, transmission and distribution companies and consumers in 1981 were added together, and divided by total gas sales in 1981 (utility and non-utility) to obtain a dollar amount of taxes of $1.17 per Mcf (see Table 7). The methodology for estimating these taxes is discussed below:

- Federal income taxes for gas producers in 1981 were estimated by applying the 1979 marginal federal income tax rate for the crude oil, natural gas liquids (NGL) and natural gas production industry to the 1981 gas marketed production value of $39.5 billion dollars.[4] This tax rate of 22% was taken from corporate income tax return reports of active corporations,[5] and excludes the foreign investment tax credit which applies to energy (primarily oil) produced by U.S. companies overseas. Federal taxes for the gas transmission and distribution industry were taken from Gas Facts: 1981.

- State and local taxes for gas producers in 1981 were estimated from IRS data by taking the amount of state and local taxes paid for the crude oil, NGL and natural gas industry as a percentage of total business receipts and applying this percentage to the 1981 gas marketed production value. This estimate of the state and local tax rate of 1.3% was assumed to exclude state severance taxes on gas produced, which are normally part of the sales price of gas. State and local taxes for the transmission and distribution industry were taken from Gas Facts: 1981.

- Severance taxes as a proportion of total purchased gas costs were estimated by calculating the basic tax rates from the State Tax Handbook[2] for 18 producing states (accounting for 93% of 1981 gas production), and applying this rate to 1981 wellhead value of marketed production (excluding Federal offshore gas production) in each state. A similar estimate was made from the State Tax Handbook for 1971, using marketed production data and tax rates for 1971. The severance tax rate as a percentage of the wellhead value of marketed production averaged 8.4% in 1971 and 6.0% in 1981. The tax rate appears to have decreased because two states -- Arkansas and Louisiana -- which based the severance tax on the volume of gas produced, as opposed to gross value, had less marketed production of gas in 1981 than in 1971, thus reducing their tax yield and their tax rate as a percentage of wellhead value.

- Other Federal taxes, i.e., federal royalties from offshore gas production in 1971 and 1981 which were assumed to represent a tax for this study, were from the United States Geological Survey.[7] Federal revenues from lease bonus payments were not included as taxes in this analysis.

- State and local taxes paid by consumers were estimated by taking a sample of the cost of 100 to 200 therms (equal to 10 to 20 Mcf) of gas with and without sales taxes for 37 gas distribution companies representing 39% of 1981 residential gas revenues. The weighted average percentage of the cost of gas which is state and local sales taxes of 6.9% was assumed to represent the sales tax rate for all sectors -- residential, commercial, and industrial, for all companies.

E. Conclusions

The rising cost of gas has put a strain on gas utility systems. The increase in the wellhead cost of gas has been the most important factor affecting the rise in the retail price of gas. Regulated wellhead gas prices, which were well below market clearing levels in the interstate market until passage of the Natural Gas Policy Act of 1978 have risen significantly over the past four years. While wellhead and retail price increases are expected to moderate in the next 5 to 10 years, utilities will continue to use a significant proportion of their revenues to purchase natural gas.

The tax burden on the gas industry is also significant, with the federal, state and local governments receiving significant revenues from the gas industry. For example, a decrease in U.S. gas sales of 1 Tcf (5% of 1981 consumption) would mean a loss of nearly $1.2 billion in Federal, state and local tax revenues.

REFERENCES

1. 1981 Joint Association Survey on Drilling Costs (Washington, DC: American Petroleum Institute), December 1982, and earlier editions.

2. State Tax Handbook (Chicago, IL: Commerce Clearing House), as of October, 1971 and October, 1981.

3. National Tax Survey 1980-Sales and Use Tax (Jackson, MS: Mississippi State Tax Commission).

4. Gas Facts: 1981 (Arlington, VA, American Gas Association), December, 1982.

5. Statistics of Income-1978-1979-Corporation Income Tax Returns (Washington, DC: Internal Revenue Service), May, 1982.

6. Natural Gas Annual 1981 (Washington, DC: U.S. Department of Energy, Energy Information Administration), November 1982.

7. Federal and Indian Lands Oil and Gas Production, Royalty Income and Related Statistics (Washington, D.C.: U.S. Department of the Interior, Geological Survey).

STATEMENT OF CHARLES G. ZEIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PUBLIC SERVICE CO., INC., OF NORTH CAROLINA, AND ACTING CHAIRMAN, ASSOCIATED GAS DISTRIBUTORS

Mr. **Zeigler**. Mr. Chairman, I am acting chairman of Associated Gas Distributors, which is a group of 54 east coast gas utilities serving approximately 11 million customers of about 25 percent of the Nation's total.

I am here to tell you that the gas distribution companies on the east coast are today in a state of real crisis. In my opinion, this crisis demands immediate solution; not merely because some companies are threatened with financial injury, but because their real victims of this crisis are the Nation's gas consumers.

Let me tell you of a situation in North Carolina where my company sells natural gas to the public including some 600 customers, industrial customers, which buy 60 percent of the gas we sell.

In the last 3 weeks, we have lost one-half of the residual oil business that our company serves, which is approximately 30 percent of the total amount of gas we sell annually. Most of this gas, of course, is sold during the nonheat sensitive time of the year.

We are very similar to many of the other utilities on the east coast. We are not unique. I can tell you from the group of personal contacts that I have had up and down the east coast from New England down through Georgia, and to others throughout the country, that those in the Midwest and the Far West are in the same boat; Chicago, Cincinnati, Los Angeles, and Buffalo.

The time has come for Congress to deal with the problem. We have gotten a good market signal. We are the marketing arm for the industry. If we cannot sell the gas, we cannot pay the pipeline, and they cannot pay the producer.

I would like to call on Fred Moring, counsel for AGD to cover some of the points of the bill that we are in favor of.

The **Chairman**. That is fine, Mr. Zeigler.

[The prepared statement of Mr. Zeigler follows:]

STATEMENT OF CHARLES G. ZEIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PUBLIC SERVICE CO., INC., OF NORTH CAROLINA, AND ACTING CHAIRMAN, ASSOCIATED GAS DISTRIBUTORS

INTRODUCTION

I AM CHARLES E. ZEIGLER. I APPEAR TODAY AS CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF PUBLIC SERVICE COMPANY OF NORTH CAROLINA, INC., AND ACTING CHAIRMAN OF THE ASSOCIATED GAS DISTRIBUTORS GROUP. I HAVE SERVED FOR THE PAST 18 MONTHS AS THE ELECTED VICE CHAIRMAN OF ASSOCIATED GAS DISTRIBUTORS, AND I AM TEMPORARILY SERVING IN THE ROLE OF CHAIRMAN OF THAT GROUP.

I AM PLEASED TO APPEAR BEFORE THIS DISTINGUISHED AUDIENCE TODAY. THE ISSUES BEFORE THE NATURAL GAS INDUSTRY ABOUT WHICH YOU HAVE HEARD SO MUCH ARE BOTH SERIOUS AND COMPLEX. I SINCERELY HOPE THAT THESE FOUR DAYS OF SUSTAINED COMMITTEE HEARINGS WILL PROVE ENLIGHTENING TO YOU AND TO THE PUBLIC, AND THAT TOGETHER WE CAN FASHION SOME REASONABLE AND EARLY REMEDIES TO PROBLEMS WHICH, IN MY OPINION, CANNOT WAIT FOR LONG.

I AM ALSO PLEASED THAT YOU HAVE CHOSEN TO HEAR FROM THE BROAD SPECTRUM OF THE NATURAL GAS TRANSMISSION AND DISTRIBUTION INDUSTRY ON THE SAME PANEL AT THESE HEARINGS. I EXPECT THAT THE TESTIMONY PROVIDED BY AMERICAN GAS ASSOCIATION, UNITED DISTRIBUTION COMPANIES, AND THE CITY OF ALBANY, GEORGIA, WILL, TAKEN TOGETHER WITH MY OWN TESTIMONY, PROVIDE YOU WITH A BETTER UNDERSTANDING OF THE COMPLEX NATURE OF THE GAS INDUSTRY AND MAY PROVIDE SOME REASONS WHY THE INDUSTRY HAS BECOME SO DIVIDED IN ITS POINT OF VIEW ON FUNDAMENTAL PROBLEMS.

IN THE BODY OF MY TESTIMONY, I HOPE TO LEAVE WITH YOU FOUR PROPOSITIONS:

A. THAT THE NATION IS NOW IN THE MIDST OF A SERIOUS NATURAL GAS/ENERGY CRISIS;

B. THAT THE ADMINISTRATION'S RESPONSE TO THIS CRISIS IS UNWORKABLE AND NONRESPONSIVE TO FUNDAMENTAL PROBLEMS;

C. THAT THE LEGISLATIVE "PRINCIPLES" SPONSORED BY WELL-MEANING CONSUMER GROUPS ARE AN INCOMPLETE FORM OF CONSUMER PROTECTION; AND,

D. THAT THE HEINZ BILL (S. 689) DESERVES YOUR THOROUGH CONSIDERATION AS A VALID AND LASTING REMEDY TO THE SERIES OF PROBLEMS CONFRONTING THIS INDUSTRY AND THIS NATION AT THIS TIME.

THE NATURAL GAS CRISIS IS HERE AND NOW

IT WOULD BE DIFFICULT, INDEED, TO OVERSTATE THE SEVERITY OF THE PROBLEMS NOW CONFRONTED BY THE GAS DISTRIBUTION INDUSTRY IN GENERAL AND BY MY COMPANY IN PARTICULAR. WITHIN THE PAST FEW WEEKS, MY COMPANY HAS SUSPENDED NATURAL GAS DELIVERIES TO INDUSTRIAL CUSTOMERS OF LONG STANDING AT A STAGGERING RATE. MY COMPANY TODAY IS NO LONGER SERVING GAS TO CUSTOMERS WHO, IN THEIR "NORMAL" YEAR, WOULD ACCOUNT FOR 30 PERCENT OF OUR INDUSTRIAL GAS SALES OR 15 PERCENT OF OUR ENTIER ANNUAL DELIVERIES OF NATURAL GAS. THESE ERSTWHILE

CUSTOMERS OF MY COMPANY ARE MEETING THEIR ENERGY REQUIREMENTS TODAY WITH NO. 6 FUEL OIL (MUCH OF WHICH IS IMPORTED) INSTEAD OF NATURAL GAS BECAUSE IT IS CHEAPER. I HAVE NO RELIABLE WAY OF PREDICTING HOW MANY MORE OF MY COMPANY'S INDUSTRIAL CUSTOMERS WILL FIND NATURAL GAS TOO EXPENSIVE AND HOW MANY CUSTOMERS I WILL HAVE NEXT YEAR. CERTAINLY I HAVE NO ABILITY TO FORECAST HOW MUCH REVENUE WILL BE AVAILABLE FROM THE CUSTOMERS WHO REMAIN ON OUR SYSTEM, AND I CANNOT NOW SAY WITH CERTAINTY HOW MUCH GAS SUPPLY WILL BE NEEDED IN THESE MAJOR INDUSTRIAL CENTERS OF NORTH CAROLINA DURING THE NEXT FEW MONTHS OR YEARS.

AT THIS POINT, I AM HOPEFUL THAT SOME IMMEDIATE MEASURE CAN BE TAKEN WHEREBY NATURAL GAS CAN BE SOLD IN NORTH CAROLINA AT COMPETITIVE PRICES AND THAT A NORMAL MARKET CONDITION CAN QUICKLY BE RESTORED. UNLESS THIS IS POSSIBLE, THERE ARE CERTAIN PREDICTABLE CONSEQUENCES WHICH ARE ADVERSE TO BOTH MY COMPANY AND THE CONSUMERS OF NORTH CAROLINA.

TURNING FIRST TO THE CONSUMERS, IT IS PREDICTABLE THAT GAS PRICES WILL CONTINUE THEIR STEADY UPWARD CLIMB FOR THE FORESEEABLE FUTURE IF THE CONDITIONS I HAVE DESCRIBED ARE NOT MET. WITHOUT A COMPETITIVE POSITION ON THE PART OF NATURAL GAS SOLD IN THE INDUSTRIAL MARKETPLACE, THE NON-INDUSTRIAL GAS CONSUMERS ARE BOUND TO PICK UP THE TAB TO AMORTIZE THE MANY MILLIONS OF CAPITAL INVESTMENT IN THEIR GAS UTILITY SYSTEMS. I DO NOT NEED TO REMIND THIS BODY OF

THE UNREST AND OUTRAGE ALREADY EXPERIENCED BY FINANCIALLY-PRESSED ENERGY CONSUMERS, NOT JUST IN NORTH CAROLINA, BUT NATIONWIDE.

THE PROBLEMS WHICH MAY VISIT MY COMPANY, ALTHOUGH SECONDARY IN YOUR MIND, ARE PRIMARY IN MINE. THOSE PROBLEMS INCLUDE MY COMPANY'S ABILITY TO MEET ITS LEGAL OBLIGATION TO PROVIDE SAFE, ADEQUATE AND RELIABLE SERVICE TO ALL CONSUMERS IN OUR SERVICE AREA, REGARDLESS OF WEATHER AND OF MY COMPANY'S ABILITY TO MEET ITS FINANCIAL COMMITMENTS TO ITS LENDERS, ITS STOCKHOLDERS, ITS EMPLOYEES, ETC. I KNOW YOU UNDERSTAND THE NATURE OF THESE PROBLEMS AND I WILL NOT DWELL ON THEM. I SIMPLY UNDERLINE THE PROPOSITION THAT THERE IS NOW A FIRST-CLASS CRISIS IN THE NATURAL GAS DISTRIBUTION INDUSTRY CAUSED BY THE FACT THAT NATURAL GAS IS OVERPRICED. I WILL CLOSE ON THIS POINT BY OBSERVING THAT THERE IS NOTHING UNIQUE ABOUT NORTH CAROLINA OR MY COMPANY INSOFAR AS GAS PRICING MATTERS ARE CONCERNED. WITHOUT PRESENTING EXHAUSTIVE INFORMATION ON THIS HIGHLY VOLATILE TOPIC, I CAN TELL YOU FROM MY PERSONAL CONVERSATIONS WITH MY COUNTERPARTS IN OTHER COMPANIES ACROSS THE NATION THAT MARKET DISARRAY AND SERIOUS MARKET LOSSES ARE THE RULE AND NOT THE EXCEPTION. THIS STATEMENT APPLIES WITH GREATER FORCE TO THOSE PARTS OF THIS NATION WHERE MANUFACTURING ACTIVITY IS CONCENTRATED AND, OF COURSE, WHERE UNEMPLOYMENT AND OTHER ECONOMIC PROBLEMS ARE ALREADY RAMPANT.

THE ADMINISTRATION'S BILL IS NOT A CONSUMER PROTECTION PROPOSAL

DESPITE ITS TITLE, IT IS MY OPINION THAT CONSUMER PROTECTION COULD NOT AND WOULD NOT BE REALIZED BY LEGISLATION ALONG THE LINES OF THE ADMINISTRATION BILL TO WHICH SECRETARY HODEL TESTIFIED EARLIER THIS WEEK. THERE ARE TOO MANY FEATURES OF THAT PROPOSAL WHICH WILL AGGRAVATE THE PROBLEMS ALREADY PLAGUING THE NATION'S GAS CONSUMERS FOR THERE TO BE ANY REAL DOUBT ABOUT THIS PROPOSITION.

THE FIRST FEATURE WHICH COMES TO MIND IN MY ASSESSMENT OF THE ADMINISTRATION'S PROPOSAL (S.615) IS THAT IT PROVIDES FOR THE DECONTROL OF OLD GAS. THAT THIS FEATURE OF S. 615 WOULD WORK HARM ON THE NATION'S GAS CONSUMERS IS READILY DEMONSTRATED. IF OLD GAS IS DECONTROLLED, GAS WHICH IS PRESENTLY SOLD ON A ROLLED-IN BASIS WOULD BE ACQUIRED BY MOST PIPELINE SUPPLIERS AT PRICES RANGING UP TO NINE OR TEN TIMES THE PRICE AT WHICH IT IS NOW PURCHASED. THE BILLIONS OF ADDITIONAL DOLLARS PAID FOR OLD GAS WILL WIND UP IN BILLS SENT TO GAS CONSUMERS BY MY COMPANY AND OTHERS LIKE IT ACROSS THIS NATION, AND WILL CAUSE A SUBSTANTIAL INCREASE IN THE AVERAGE PRICE AT WHICH GAS IS SOLD TO CONSUMERS. MOREOVER, OLD GAS DECONTROL WOULD REDUCE THE INCENTIVE OF PRODUCERS TO PURSUE NEW GAS RESERVES VIGOROUSLY. THIS IS NOT CONSUMER PROTECTION. A SECOND ELEMENT OF THE ADMINISTRATION'S PROPOSAL WHICH ALSO OFFENDS THE CONSUMER'S INTEREST IS ITS TREATMENT OF THE GAS

PIPELINE SEGMENT OF THE INDUSTRY. IN ACCORDANCE WITH SECTION 603 OF THE ADMINISTRATION'S PROPOSAL (WHICH AMENDS THE NGPA TITLE VI), GAS PIPELINES WOULD BE ASSURED AT LEAST THEIR PRESENT LEVELS OF PURCHASED GAS COSTS FOR A PERIOD OF YEARS AND, COMMENCING 1-1-86, WOULD AGAIN BE ELIGIBLE FOR THE "GUARANTEED PASSTHROUGH" BY WHICH THE CONSUMER HAS BEEN VICTIMIZED IN THE LAST SEVERAL YEARS. IN MY JUDGMENT, THE AVAILABILITY OF VIRTUALLY UNLIMITED PIPELINE RATES ON THE PART OF THE INTERSTATE PIPELINE COMPANIES HAS BEEN ONE OF THE BASIC FLAWS IN THE ADMINISTRATION OF THE NGPA TO DATE. UNLESS AND UNTIL SOME REASONABLE STEPS ARE TAKEN BY EITHER FERC, THE COURTS OR BY CONGRESS TO LIMIT THE PIPELINES' UNTRAMMELED RIGHT (AS INTERPRETED BY FERC) TO PASS ON TO GAS DISTRIBUTORS ANY AND ALL PAYMENTS FOR GAS PURCHASED IN THE FIELD, I CAN SEE NO WAY IN WHICH THE RATES MY COMPANY PAYS WILL GO DOWN. I FIND IT BOTH ALARMING AND DISAPPOINTING THAT THE ADMINISTRATION BILL HAS OVERLOOKED THIS FUNDAMENTAL INSTITUTIONAL BARRIER TO RESTORE PIPELINE RATES TO SOME SEMBLANCE OF REALITY. THIRD, AND FINALLY, I DO NOT BELIEVE THE CONSUMER WOULD BE WELL SERVED IF FERC JURISDICTION WERE EXPANDED TO INCLUDE GAS DISTRIBUTION COMPANIES AS PROPOSED IN SECTION 316 OF THE ADMINISTRATION BILL. IN MY EXPERIENCE, FERC HAS SHOWN NO REAL ABILITY TO COPE WITH ITS JURISDICTION TO REGULATE GAS PRODUCERS (WITH RESPECT TO 104 GAS) OR GAS PIPELINES, AND I HAVE NO CONFIDENCE IN ITS ABILITY TO REACH OUT AND DEVELOP APPROPRIATE REGULATIONS AFFECTING THE TRANSPORTATION OF GAS BY LOCAL DISTRIBUTION COMPANIES TO END USERS. I BELIEVE THAT ANOTHER LAYER OF REGULATION OF THIS

TYPE ON TOP OF THE COMPREHENSIVE STATE REGULATION ALREADY IMPOSED ON GAS DISTRIBUTION COMPANIES WOULD BE A TRAGIC MISTAKE, AND THAT THE CONSUMER WOULD BE ONCE AGAIN THE VICTIM. I AM SURPRISED THAT THIS ADMINISTRATION'S COMPREHENSION OF FEDERALISM HAS COME TO EMBRACE FEDERAL CONTROLS ON STATE REGULATED GAS UTILITIES.

THE LEGISLATIVE PRINCIPLES ADVOCATED BY CONSUMER GROUPS ARE INCOMPLETE AND MISCHIEVOUS

IN RECENT DAYS, AT LEAST TWO ORGANIZATIONS WHICH PURPORT TO REPRESENT THE INTEREST OF THE CONSUMER HAVE COSPONSORED A STATEMENT OF "LEGISLATIVE PRINCIPLES" WITH WHICH I NOW TAKE ISSUE. THE PARTICULAR PRINCIPLES WITH WHICH I AM MOST CONCERNED IN THIS REGARD ARE THOSE WHICH WOULD (A) CALL FOR A "ROLL BACK" IN GAS PRICES TO THOSE WHICH WERE PREVELANT IN JANUARY 1982, AND (B) WHICH PROVIDE FOR AN EXTENSION OF NGPA CEILING PRICE CONTROLS FOR A PERIOD OF TWO YEARS OR SO. IN MY JUDGMENT, NEITHER OF THESE PROVISIONS CAN BE SQUARED WITH THE CONSUMER'S BEST INTEREST.

LET ME SAY A WORD ABOUT THE ROLL BACK IDEA. IF NATURAL GAS WELLHEAD PRICES WERE BY LEGISLATIVE FIAT SUDDENLY RESTATED AT JANUARY 1982 LEVELS, THE RESULTING REDUCTION IN SUCH PRICES TO THE CONSUMER SHOULD PROBABLY BE MEASURED, AS TO THEIR NATIONWIDE ANNUAL IMPACT, ONLY IN THE SEVERAL BILLION DOLLARS RANGE. IN MY OPINION, SUCH MODEST RATE REDUCTIONS AS THOSE WOULD BE LIKE USING A FLYSWATTER TO BRING DOWN AN ELEPHANT. THE TIME

HAS COME WHEN THE PUBLIC AND THE INDUSTRY AND THOSE WHO GOVERN MUST REALIZE, IF THEY HAVE NOT ALREADY, THAT GAS PRICES HAVE "OVER SHOT THE MARK" BY MANY BILLIONS OF DOLLARS STATED ON A NATIONAL BASIS. TO PREDICT THAT A ROLL BACK TO JANUARY 1982 PRICES WOULD SUFFICE TO PROTECT GAS CONSUMERS FROM EXCESSIVE PRICES WOULD SIMPLY BE INCORRECT.

I ALSO BELIEVE THAT A TWO-YEAR EXTENSION OF CONTROLS WOULD BE COUNTER PRODUCTIVE IN TERMS OF CONSUMERS' NEAR-TERM AND LONG-TERM INTEREST. AS ALL RESPONSIBLE RESEARCH AND STUDIES INDICATE, THIS NATION DOES NOT HAVE AN ADEQUATE SUPPLY OF PROVED NATURAL GAS RESERVES. THERE ARE PIPELINES SERVING MAJOR METROPOLITAN CITIES OF THE U.S. TODAY THAT ARE LIVING "HAND TO MOUTH" AND DO NOT HAVE ENOUGH RESERVES UNDER CONTRACT TO LAST MORE THAN THREE TO SIX YEARS AT THEIR PRESENT SALES LEVELS. IF THE CEILING PRICE CONTROLS ADOPTED IN NGPA WERE EXTENDED FOR A PERIOD OF TWO YEARS, IT IS PAINFULLY OBVIOUS TO EVERYONE THAT THE DECONTROL OF NEW GAS LONG AWAITED AND NOW EXPECTED TO OCCUR ON 1-1-85 WOULD NOT OCCUR. ACCORDINGLY, THE REWARDS FOR FINDING NATURAL GAS RESERVES IN 1985 AND 1986 WOULD BE SUBSTANTIALLY LESS THAN UNDER PRESENT LAW AND NUMBER OF ACTUAL RIGS DRILLING THE WILD CAT WELLS SO VITALLY NEEDED IN THIS COUNTRY WOULD BE EVEN LESS THAN IT IS TODAY. I AM NOT NOW PREDICTING NATIONWIDE SHORTAGE OF GAS AT ANY PARTICULAR TIME. WHAT I AM PREDICTING IS THAT AN EXTENSION OF CONTROLS, EVEN FOR A TWO-YEAR PERIOD, WILL HASTEN WHATEVER SHORTAGE MAY OTHERWISE COME ABOUT IN THE FUTURE. AT A TIME

WHEN THE NEED FOR DOMESTIC EXPLORATION OF NATURAL GAS IS CRITICAL TO ENABLE BOTH PIPELINES AND DISTRIBUTORS TO MEET THEIR LONG-TERM OBLIGATIONS TO THEIR CUSTOMERS, IT WOULD BE FOOLISH, IN MY OPINION, TO EXTEND THE CONTROLS ADOPTED IN NGPA TO REMOVE THE SUBSTANTIAL INCENTIVES WHICH 1-1-85 DECONTROL IS EXPECTED TO CREATE FOR GAS EXPLORATION. FOR THIS REASON, AND OTHERS STATED EARLIER, I URGE THE COMMITTEE TO BE CAREFUL IN EMBRACING THOSE PRINCIPLES WHICH, HOWEVER WELL INTENDED, WOULD NOT TRULY PROTECT THE NATION'S GAS CONSUMERS.

THE HEINZ BILL PROVIDES THE BASIS FOR A COMPREHENSIVE AND LASTING SOLUTION TO THE CONSUMERS' AND THE INDUSTRYS' MAJOR CONCERNS

AS STATED AT THE OUTSET, MY COMPANY AND THE ASSOCIATED GAS DISTRIBUTORS SUPPORT S.689, INTRODUCED LAST WEEK BY SENATOR HEINZ. WE TAKE THIS POSITION AFTER A LONG AND DIFFICULT SERIES OF MEETINGS AMONG OURSELVES, WITH OUR FRIENDS IN THE PIPELINE INDUSTRY AND STILL OTHER FRIENDS IN THE GAS DISTRIBUTION INDUSTRY OUTSIDE THE EAST COAST AREA. WE BELIEVE IN THE HEINZ PROPOSAL, AND WE ARE PREPARED TO SAY AT THIS TIME THAT IT IS THE BEST OF THE OPTIONS AVAILABLE FOR CONSIDERATION BY THIS COMMITTEE. WE TAKE THIS POSITION FOR THE REASONS OUTLINED BELOW.

THE HEINZ BILL MAKES AVAILABLE SUBSTANTIAL RATE REDUCTIONS FOR NATURAL GAS CONSUMERS IMMEDIATELY UPON ITS ENACTMENT. AS WE UNDERSTAND THE OPERATION OF SENATOR HEINZ'S PROPOSAL, RATE

REDUCTIONS APPROXIMATING SOME $25 BILLION WOULD BECOME AVAILABLE DURING THE FIRST YEAR AFTER ITS ENACTMENT. RATE REDUCTIONS OF THIS ORDER OF MAGNITUDE ARE, IN MY OPINION, ABSOLUTELY ESSENTIAL TO RESTORE SOME MEANINGFUL INTERFUEL COMPETITION, PARTICULARLY IN THE INDUSTRIAL ENERGY MARKETPLACE. THESE RATE REDUCTIONS TRANSLATE INTO AT LEAST $200 PER RESIDENTIAL CUSTOMER SAVINGS IN THE FOLLOWING YEAR AFTER ENACTMENT OF THE HEINZ PROPOSAL. WHILE THIS MAY BE A SOMEWHAT MODEST RATE REDUCTION IN THE MINDS OF SOME, IT MAY MEAN A DIFFERENCE BETWEEN HEATING OR EATING TO MANY. THE DEGREE OF CONCERN OR OUTRAGE ON THE PART OF THE NATION'S NATURAL GAS CONSUMERS IS HARD TO OVERSTATE. I URGE YOU TO CONSIDER THE $25 BILLION IN RATE REDUCTIONS OFFERED BY S.689 AS A MINIMUM NUMBER WHICH WOULD BE MADE LARGER UNDER THAT BILL AS THE EFFECTS OF MARKET-OUT PROVISIONS, INDEFINITE ESCALATORS AND TAKE-OR-PAY LIMITATIONS BECOME MORE MEASURABLE OVER TIME. IF THE CONGRESS SETTLES FOR ANY ROLL BACK LESS THAN THIS AMOUNT, I BELIEVE IT WILL HAVE MADE A BAD BARGAIN.

THE HEINZ PROPOSAL PROVIDES AN EFFECTIVE RESOLTUION OF THE CONTRACTS PROBLEM SO WIDELY DISCUSSED IN RECENT YEARS. TAKE-OR-PAY PROVISIONS, INDEFINITE PRICE ESCALATOR PROVISIONS AND THE ABSENCE OF MEANINGFUL MARKET-OUT CONTRAT RIGHTS ARE THREE KEY ELEMENTS OF THE CONTRACTS PROBLEM ON WHICH ALL PARTS OF THE INDUSTRY HAVE COME TO AGREE. ON SOME BASIS, THESE ARRANGEMENTS MUST BE ADDRESSED AND RESOLVED IF THE INDUSTRY IS TO AVOID A

MASSIVE NEW WAVE OF UNACCEPTABLE RATE INCREASES IN JANUARY 1985, AS NGPA DECONTROL TAKES EFFECT. THE HEINZ BILL PROVIDES PERMANENT ANSWERS TO EACH OF THESE THREE PROBLEMS WITH EXISTING WELLHEAD GAS SALES CONTRACTS, AND WE BELIEVE THESE ANSWERS ENDURE FOR THE LONG-TERM FUTURE OF THE INDUSTRY.

ANOTHER DISTINCTION OF THE HEINZ PROPOSAL IS THE ABSENCE OF ANY "CAPPING" MECHANISM WHEREBY A NEW FORMULA FOR GAS PRICING IS INTRODUCED TO RESOLVE 1985 RATE INCREASES FOR GAS. IN MY EXPERIENCE, FORMULAS FOR GAS PRICES DO NOT WORK. CONDITIONS CHANGE, TECHNOLOGY CHANGES, THE WEATHER CHANGES AND OTHER UNCONTROLLABLE FACTORS INEVITABLY DEFEAT MAN'S EFFORT TO DEVISE FORMULAS WHICH SIMULATE HOW THE MARKET SHOULD WORK. I AM PLEASED TO SEE THAT SENATOR HEINZ HAS OMITTED FROM HIS BILL ANY NEW FORMULA TO APPLY DURING THE PERIOD OF TRANSITION TO WELLHEAD PRICE DECONTROL. I CONGRATULATE HIM ON THAT CHOICE, AND I URGE THIS COMMITTEE TO RESIST THE TEMPTATION TO ONCE AGAIN INVENT A CEILING PRICE WHICH WILL PROTECT THE GAS CONSUMER.

THE HEINZ PROPOSAL IS WELL DESIGNED TO MEET THE NATION'S GAS SUPPLY NEEDS. AS INDICATED EARLIER, GAS SUPPLY IS AN ABIDING AND URGENT CONCERN FOR THOSE OF US WHO HAVE LONG-TERM GAS SALES OBLIGATIONS. BY KEEPING THE NGPA DECONTROL SCHEDULE IN TACT, THE HEINZ BILL OFFERS THE PROMISE THAT SUBSTANTIAL REWARDS WILL CONTINUE TO BE AVAILABLE FOR THOSE WHO FIND NEW GAS IN THE FUTURE. NO DECONTROL OF OLD GAS COULD POSSIBLY IMPROVE THE REWARDS AVAILABLE FOR FINDING NEW GAS. FOR THESE REASONS, I BELIEVE S. 689 WILL ALLOW NATURAL GAS EXPLORERS TO RESUME THEIR ALL IMPORTANT EFFORTS, AND I APPLAUD SENATOR HEINZ'S JUDGMENT THAT THESE PRODUCERS HOLDING LARGE INVENTORIES OF OLD GAS DO NOT NOW NEED AND SHOULD NOT BE GIVEN A MULTI-BILLION DOLLAR WINDFALL.

FINALLY, THE HEINZ BILL EMBODIES AN APPROPRIATE DEGREE OF WHAT WE CALL "PIPELINE ACCOUNTABILITY." IT RESTORES THE PRUDENCE STANDARD TO PIPELINE RATE REGULATION AND, IN SO DOING, REVIVES THE "JUST AND REASONABLE" STANDARD WHICH HAD BEEN IMPLEMENTED FOR SOME 40 YEARS OF NATURAL GAS ACT PIPELINE RATE REGULATION. I AM ALSO PLEASED TO SEE THAT SENATOR HEINZ HAS CHOSEN TO INCLUDE IN HIS BILL ECONOMIC INCENTIVES FOR PIPELINES TO PROVIDE TRANSPORTATION SERVICE. MANY GAS DISTRIBUTORS, INCLUDING MY COMPANY, HAVE BUT ONE PIPELINE SUPPLIER TO MEET ALL THEIR REQUIREMENTS. IMAGINE WHERE WE WOULD BE IF OPEC OWNED ALL THE RETAIL GASOLINE OUTLETS IN THE U.S. I BELIEVE THE TIME HAS COME WHEN PIPELINE MONOPOLIES CAN NO LONGER BE JUSTIFIED, AND THAT GAS DISTRIBUTORS AND THEIR CUSTOMERS SHOULD RECEIVE SOME BENEFITS AVAILABLE THROUGH COMPETITION.

IN CONCLUSION, LET ME SAY THAT THE NATURAL GAS CRISIS IS REAL, IS HERE, AND IT IS NOT ONE THAT ANYONE RELISHES. I URGE YOU TO TAKE SERIOUSLY THE EXTENT OF THIS PROBLEM AND THE DEPTH TO WHICH THAT PROBLEM HAS BEEN ADDRESSED BY SENATOR HEINZ'S BILL.

I APPRECIATE THE OPPORTUNITY TO BE HERE TODAY AND WISH YOU GOOD LUCK.

STATEMENT OF FRED MORING, COUNSEL, ASSOCIATED GAS DISTRIBUTORS

Mr. MORING. I am Fred Moring. And I am here today to add to Mr. Zeigler's remarks, and say just a few words about why AGD supports Senator Heinz' bill, S. 689. In my judgment, Senator Heinz' bill strikes a major blow on behalf of the Nation's gas consumers, a blow which could reduce gas prices nationwide by a very large amount in a period of a few months.

I say this after analyzing the bill in general, and after calculating what I consider the profound effects of section 316(d) found in section 203 of S. 689. Let me explain.

Some research that I have completed in the last few days tells me some very important things. It tells me that the gas producing industry has probably overreached its effort to maximize natural gas revenue.

One key fact proves this point. The gas pipeline and gas producing segments of the industry have followed and observed an unsavory contracting practice, which according to my calculations will cost this Nation's gas consumers about $25 billion in 1983 alone.

The practice to which I refer known in the trade as sweetheart deals would be outlawed, and its effect undone immediately by section 203 of the Heinz bill. Accordingly, if that bill were the law tomorrow, I believe that we could expect to see gas bills reduced on a nationwide basis by about $25 within a short period of time.

I recognize that my testimony may come as a surprise to some. I am telling you that the gas producers and the gas pipelines, with the tacit approval of FERC, have unfairly extracted some $25 billion per year from my clients and from your constituents. This is about one-third of the gas producing industry's gross revenue in 1982.

I think that it is time the Congress and the public understood how this was done and that it is time to put a stop to it. I have an idea that FERC itself could put a stop to it using authority that you gave them a long time ago. I will save that for later and let my friends from other gas industry groups have a chance to testify.

Thank you.

The CHAIRMAN. Thank you.

Mr. Cooper.

STATEMENT OF C. WILLIAM COOPER, CHAIRMAN, UNITED DISTRIBUTION COS.

Mr. COOPER. Mr. Chairman, members of the committee, I represent the United Distribution Cos., which is an ad hoc group of 33 distribution utilities.

We appreciate this opportunity to testify. We feel, as Mr. Lawrence and Mr. Zeigler have said, that the distribution industry is at a crisis point and legislation must be adopted.

We are very happy that you have commenced hearings on legislation. We hope that sound legislation will be reported out by your committee.

I might say in regard to the crisis situation, to emphasize it, that companies in our area, and they are in the industrialized area of the Midwest, in large measure, are losing load right and left. Gas prices have increased above and are continuing to rise steadily above market clearing levels.

I had a call yesterday from a consumer's power company in Michigan telling me of lost loads of great size that are occurring right today because of increasing prices. We have heard recently from a company in Ohio that they will expect to lose, at present price levels, 44 percent of their industrial load this year.

Something must be done. As to the bill that has been submitted by the administration, we earnestly oppose that bill for three reasons.

In the first place, we believe that the decontrol of old gas is very much opposed to the public interest. It will increase the cost of gas materially without producing new supply and it will greatly depreciate the ability of the industry to secure new supplies.

In the second place, the total restructuring of the supply contracts can only lead to higher prices in the future, and the bill affords absolutely no protection to the consumers long term and even short term.

We are in support of legislation that will stay within the framework of NGPA and attack the problems of the industry directly. As we see it, there are four major things to be done.

The first thing is to turn down current prices, and that, we would submit, should be done through a revision of the ceiling prices in the act. We would like to see those prices rolled back to levels of August 1, 1982, that being the time when we feel prices crossed market clearing levels.

We think then they should be trended from then on in accordance with the way in which competition faced by the industry trends. That should allow the industry to operate satisfactorily.

We would like to see taker-pay clauses handled in a very effective fashion, both short term and long term.

The same is true of indefinite price redetermination clauses. The worst of those should be outlawed, and there should be means placed in substitution for sound renegotiation or periodic redetermination of prices.

We feel that one of the most important things that should come out of any legislation is to improve the leverage of the market against the pipelines so that the pipelines will have more incentive to control their pricing and to supply arrangements in the field.

We have submitted some proposed forms of legislative principles which deal with those things. We have commented also on Senator Heinz 'bill in our statement. We are very happy to see him introduce the bill as he did. We suggest certain changes in it, which we would be glad to discuss.

The CHAIRMAN. Thank you very much, Mr. Cooper.

[The prepared statement of Mr. Cooper follows:]

STATEMENT OF C. WILLIAM COOPER, CHAIRMAN, UNITED DISTRIBUTION COS.

I

OPENING STATEMENT

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

United Distribution Companies ("UDC") is an ad hoc group of 33 gas distribution utilities. In the aggregate, the Group renders over 20% of all gas utility service throughout the Nation and operates in 10 States. The names of the Members, the locations of their principal offices and the character of regulatory work in which the Group has taken part since it was formed in 1969 are set forth in Part II of this statement.

We were privileged to present our views at hearings of your Committee during 1982; and we particularly appreciate this opportunity to comment on S.615, the Administration Bill, as well as other bills pending before your Committee in this Congress.

The Administration Bill embodies three interrelated proposals which constitute its essence; and it is to these that our remarks will be directed. They are:

1. The decontrol of old Section 104 gas, along with all other classes of gas on or before January 1, 1986;
2. The granting of termination rights to both parties to all existing field supply contracts, during 1985, so that producers of gas can seek new contracts, particularly for old gas, and pipelines can

seek compensatory and ameliorating price arrangements with other producers; and

3. The imposition of temporary limitations on gas costs and pipeline flow-through during the period ending January 1, 1986, while this decontrol process and massive supply rearrangement are underway.

UDC strongly opposes this whole interrelated proposal, -- the very heart of the Administration Bill --, for the following reasons:

1. The decontrol of old Section 104 gas, coupled with the massive redo of contractual arrangements necessary to that end will cause irreparable public harm of two kinds:
   (a) It will seriously impair the ability of the industry to generate necessary new reserves, because the prices which can be paid for future exploration and development will be reduced; and
   (b) It will place undue and unfair economic burdens on consumers in major areas of the Nation.
2. The wholesale termination of existing supply arrangements and wholesale making of new arrangements during the year 1985, pursuant to Section

316, are fraught with problems of major import, each capable of causing irreparable harm to utility service and the public:

(a) the "market-outs" involve serious constitutional questions; and, if the same are held illegal by the Supreme Court, the industry will be in indescribable chaos;

(b) the wholesale redo of supply arrangements would represent such a massive, complex and difficult undertaking that, only by the Grace of God could the process achieve sound overall field values; and the Bill offers absolutely no protection against excessive results which would, in fact, drive utility service and consumers to the wall;

(c) the Bill fails to incorporate any protections against a repetition in new contracts, made during these supply rearrangements, of those excessive take-or-pay provisions and onerous price redetermination clauses which are now plaguing utility service and consumers; and

(d) the Bill fails to incorporate any provisions which would bring much needed leverage of utility service and consumer tolerances to bear on the prices which will be incorporated in these new contracts.

3. The much advertised "consumer" protection provisions in Title I of the Bill are misdirected, illusory and meaningless from the standpoint of utility service and consumers, for two very important reasons:

   (a) Title I as written envisions that field prices will continue to rise from now until 1986. But, competitive fuel prices are dropping steadily; and every economic rule in the book says that Congress should act to reduce field prices in this period, not increase them. Utility service and consumers desperately need price relief, not further price increases.

   (b) The limitation placed on PGA flow-throughs is undoubtedly intended by the Administration to place a limit on the prices and contractual terms emanating from the wholesale redo of contracts during 1985. But, PGA's resulting from those contracts would not be filed until 1986 and, by then, Title I would have vanished. The lid would be off. Any prices or undue burdens which producers would have been able to exact during the massive restructuring of supply would take full effect. Pipelines would file for and collect whatever they have agreed to in the new contracts.

Congress cannot, in good conscience, deregulate Section 104 gas on January 1, 1986, authorize the proposed wholesale redo of all existing supply arrangements during the year 1985 and then turn this industry loose on January 7, 1986, with the mere hope that all will have been done, and thereafter go forward, in a manner befitting the public interest. To do so, would leave utility service and consumers exposed on January 1, 1986 to whatever may emanate from those new supply arrangements -- any level of prices, -- any take-or-pay requirements, however excessive; -- any price redetermination provisions, however outlandish. That would be the height of governmental folly.

UDC submits that the only sensible and responsible course is for Congress to work from the framework of NGPA and deal directly with the severe and felt problems which have come into being since that statute was enacted. In that way, the industry can be safely and surely set to rights, -- legislative objectives of keen interest when one is dealing with public utility service and millions of consumers throughout the Nation.

Taking this view of the situation, the following critical problems must be recognized and soundly corrected:

1. Field prices have risen beyond market clearing levels and are being pressed steadily upward by

escalation formulae in NGPA. Competitive costs of fuel and energy are declining. Natural gas is being priced out of the market. The current steady increase in field prices must be brought to an end and turned downward through Congressional action as to both ceiling prices and Section 107 contract prices.

2. Excessive take-or-pay requirements for high cost field supplies are causing irreparable harm. They must be curtailed; and sound means for contract correction must be provided in substitution.
3. Unsound indefinite price redetermination clauses in producer-pipeline contracts can ruin utility service following decontrol. They must be outlawed; and, in their stead, there must be substituted sound means for adjusting prices in long-term field supply contracts, up or down, in accordance with changes in the value of gas for the market for which it is produced.
4. Minimum bill and other provisions in pipeline tariffs for sales to distribution utilities currently prevent the demand and price tolerances of utility service from limiting the prices and terms on which gas is purchased in the field. The market must impose these limits. Pipelines cannot,

> as they now do, pay prices for gas which utilities cannot in turn efficiently sell. Corrections in pipeline tariffs are essential to the sound working of the natural gas market. And Congress must, we submit, mandate these corrections.
>
> In short, any corrective legislation must provide utility service with that leverage over pipeline operations which is critical to a sound resource market, operating in close competition with other fuels.

A detailed statement of the foregoing problems and UDC's legislative principles for their correction is attached as Appendix A hereto.

UDC submits that corrective legislation must encompass these elements as a fundamental base. None are encompassed within or compatible with the Administration Bill, its rationale or its principles.

Turning now to other pending Bills, we would offer the following comments.

S.60, S.239, S.291, S.293, and S.370 are, each, intended to deal narrowly with one or two situations in the overall picture. But, in UDC's opinion, limited action with regard to one or two items cannot alone set this industry on a sound course for the future. Comprehensive action dealing broadly with current price trends, contractual practices and pipeline

- distributor relationships must be mandated and placed in operation.

S.689, as introduced by Senator Heinz is intended to correct industry problems starting from the framework of NGPA, and, for reasons mentioned above, UDC applauds this general concept. This Bill would maintain Section 104 gas under control, avoid the complete redo of supply arrangements which decontrol of Section 104 gas would entail, and seek to provide effective and lasting protection for utility service and consumers. In every sense of the word; it is an obverse to the Administration Bill.

However, just as the Administration Bill offers no protection to utility service and consumers, this Bill, in UDC's opinion, goes too far in the other direction and would have serious long term problems from the standpoint of supply.

Our reasons for so stating will be set forth in Section VI below; and we there compare, with S.689, the several legislative principles outlined above and set forth in detail in Appendix A hereto. UDC offers the same to the Committee for its consideration.

We will be more than happy to be of any assistance that may be desired by the Committee or its Staff.

II

UNITED DISTRIBUTION COMPANIES AND ITS WORK

UDC is an ad hoc group of organizations engaged in rendering gas utility service to the general public.

There are 33 organizations in UDC at this time; and their service aggregates over 20% of all gas utility service throughout the United States.

The Members render service in the states of:

ARKANSAS
ILLINOIS
INDIANA
MICHIGAN
MISSOURI
NEW YORK
OHIO
PENNSYLVANIA
WEST VIRGINIA
WISCONSIN

Among the metropolitan areas served are:

Akron
Albany
Buffalo
Chicago
Cleveland
Dayton
Detroit
Indianapolis
Jackson
Milwaukee
Pittsburgh
Peoria
Rochester
Syracuse

The names of the companies and their places of service are set forth on a following page. Taken as a whole, the Group presents a representative cross section of the industry, comprising, as they do, companies of all sizes in widely differing areas of the country.

UDC was formed in 1969 as a result of growing gas shortages; and it, thereafter, participated in all "field price" proceedings under the Natural Gas Act, for the purpose of seeing that sound rates were established in the interest of long term supplies for utility service. Since passage of the Natural Gas Policy Act ("NGPA") and its four companion statutes in 1978, UDC has participated in a host of rulemakings and much litigation in an effort to see that sound and workable rules were and are established.

The growth in problems facing the industry has now led UDC to take part in legislative matters. The Group has been working actively in support of the Low Income Energy Assistance Program; and advocates comprehensive legislative response to field pricing problems.

MEMBERS OF
UNITED DISTRIBUTION COMPANIES

Company	State of Operation	Principal City Served
ASSOCIATED NATURAL GAS CO.	Arkansas and Missouri	Blytheville
BATTLE CREEK GAS COMPANY	Michigan	Battle Creek
CENTRAL ILLINOIS LIGHT COMPANY	Illinois	Peoria
CENTRAL ILLINOIS PUBLIC SERVICE CO.	Illinois	Springfield
CITIZENS GAS & COKE UTILITY	Indiana	Indianapolis
CITIZENS GAS FUEL COMPANY	Michigan	Adrian
CONSOLIDATED GAS SUPPLY CORP.	West Virginia	Clarksburg
CONSUMERS POWER COMPANY	Michigan	Jackson
THE DAYTON POWER AND LIGHT COMPANY	Ohio	Dayton
EAST OHIO GAS COMPANY	Ohio	Cleveland
EQUITABLE GAS COMPANY	Pennsylvania	Pittsburgh
ILLINOIS POWER COMPANY	Illinois	Decatur
INDIANA GAS COMPANY	Indiana	Indianapolis
KOKOMO GAS AND FUEL COMPANY	Indiana	Kokomo
MICHIGAN CONSOLIDATED GAS COMPANY	Michigan	Detroit
MICHIGAN GAS UTILITIES COMPANY	Michigan	Monroe
MISSOURI UTILITIES COMPANY	Missouri	Columbia
NATIONAL FUEL DISTRIBUTION CORP.	New York and Pennsylvania	Buffalo and Erie
NIAGARA MOHAWK POWER CORPORATION	New York	Syracuse
NORTH SHORE GAS COMPANY	Illinois	Chicago
OHIO GAS COMPANY	Ohio	Bryan
ORANGE & ROCKLAND UTILITIES, INC.	New York	Spring Valley
THE PEOPLES GAS LIGHT AND COKE CO.	Illinois	Chicago
PEOPLES NATURAL GAS COMPANY	Pennsylvania	Pittsburgh
RICHMOND GAS CORPORATION	Indiana	Richmond
RIVER GAS COMPANY	Ohio	Marietta
ROCHESTER GAS & ELECTRIC CORP.	New York	Rochester
THE TOLEDO EDISON COMPANY	Ohio	Toledo
WEST OHIO GAS COMPANY	Ohio	Lima
WISCONSIN FUEL AND LIGHT COMPANY	Wisconsin	Manitowoc
WISCONSIN GAS COMPANY	Wisconsin	Milwaukee
WISCONSIN NATURAL GAS COMPANY	Wisconsin	Racine
WISCONSIN SOUTHERN GAS COMPANY	Wisconsin	Lake Geneva

III

THE DECONTROL PROVISION IN TITLE II OF THE BILL WILL CAUSE IRREPARABLE PUBLIC HARM BOTH NATIONALLY AND REGIONALLY

A. INTRODUCTION

Looked at candidly, the only long term effect of Title II of the Bill is to decontrol Section 104 gas--the old, imbedded gas dedicated to interstate commerce prior to NGPA and generally held by major oil and gas producers. This conclusion is inescapable, because all "new gas" dedicated to interstate commerce in recent years will soon be decontrolled under NGPA as it now stands.

It is, in this light, that the Administration Bill must be appraised.

B. RAISING PRICES FOR SECTION 104 GAS WILL DEPRECIATE PRICES WHICH CAN BE PAID FOR FUTURE RESERVES AND INEVITABLY CURTAIL FUTURE EXPLORATION AND DEVELOPMENT.

Average gas purchased costs of interstate pipelines have been pushed to and above market clearing levels in recent months. Consumers in every class are switching part or all of their loads to competitive fuels; and utility service can stand no more. By way of example, this week, two automobile manufacturers, one auto supplier and one paper manufacturer long served by Consumers Power Company in Michigan switched to other fuels because of increases in gas rates. Similar losses have occurred, and are occurring, on the systems of other UDC Members.

The glaring fact is that, with competitive fuel prices dropping steadily, pipeline costs of supply must decline.

All this means that, if Section 104 gas is decontrolled and producers of that gas push for increases--as they obviously will--prices of new gas must be reduced. Pipelines must maintain a marketable average cost of gas and most, if not all pipelines have now reached or exceeded the price limit on marketability. Thus, to the extent lower-cost components of total gas costs are increased, the average gas cost will exceed market tolerances unless the cost of other supply components can be reduced by corresponding amounts.

Considering the economic strength and bargaining power of major oil and gas producers, the push for higher prices for Section 104 gas will be strong, and resulting downward changes in new gas prices will be large.

Major producers of Section 104 gas will argue that, if they receive more for present reserves, they will have more to spend for future exploration and development. But, will this, in fact, occur? They could as well devote the money to oil or coal development if the return is better. And, it is obvious that, if the future prices which can be paid by interstate pipelines are depreciated by overpayment for imbedded supplies, there is less incentive for Section 104 producers to explore for gas and more likelihood that funds received from imbedded supplies will be devoted to oil, coal or other investment opportunities. Regardless of the level of earnings for old gas, exploration for new gas will be decided on the basis of the price and return for such gas.

So, too, reductions in the amount which can be paid for future supplies will surely and directly reduce exploration and development by independent and other operators who do not have the benefit of Section 104 gas.

The possibility of future shortages is high and Congressional response to current problems must be shaped with this in mind.

From every standpoint, the public will be benefited by reserving available funds for new reserves rather than squandering them on imbedded reserves.

C. THE RESHUFFLING OF CONTRACTUAL ARRANGEMENTS WHICH LIES AT THE HEART OF THE ADMINISTRATION PROPOSAL WILL THROW MAJOR COST INCREASES ON HARD HIT INDUSTRIAL AREAS IN INDIANA, ILLINOIS, MICHIGAN, NEW YORK, OHIO, PENNSYLVANIA AND OTHER STATES SERVED BY UDC COMPANIES.

The Administration Bill approaches this complex subject from a national average point of view and it is conceivable that, on average, increases in old gas prices could be offset by decreases in new gas prices.

But this overall reshuffling would have disastrous consequences for areas of the country served by interstate pipelines which had the foresight to create adequate reserves of imbedded Section 104 gas. When their prices for large imbedded reserves are increased, either one of two major detriments occur:

1. The prices which they can pay for necessary new reserves are depreciated much more than are those prices which can be paid by other pipelines which have small imbedded reserves; and they cannot compete for necessary new reserves; or
2. If they buy the new reserves at competitive levels, their average costs will fly above costs of competitive fuels, and disruptions of utility service will occur.

Either one of these two consequences is of extreme detriment to those areas of the Nation which are served by interstate pipelines having sizeable imbedded supplies; and, by and large, these are the industrialized areas served by UDC companies.

D. THE ECONOMIC PRINCIPLE DOES NOT WARRANT THE HARM WHICH WOULD BE CAUSED.

Decontrol of Section 104 gas is advanced on the ground that this is a natural resource industry and that every well should be entitled to the same value as every other well regardless of when drilled or dedicated to interstate commerce.

But, can it be said that embodiment of this principle in new law is right and proper--or required by the public interest--when so to do will depreciate future drilling and work great harm to large sections of the Nation, as has been outlined above?

UDC sincerely believes that the response must be in the negative. It is well known that, by and large, Section 104 gas was drilled by major oil and gas producers in earlier days of much lesser cost and when it was known that the price of the supply would be regulated. In many instances, moreover, the producer had the benefit of advance payments (i.e., interest free financing) provided by the interstate pipeline and its customers for the very purpose of creating large dedicated reserves on which they could count in the future.

To say that, as a matter of equity and public concern, these producers should receive the same price as producers of new gas--when to do so will result in public harm--stretches the imagination.

The National Interest lies in developing new reserves for the future; and that concern must guide decision in this matter.

E. ALLEGED PRICING DIFFERENCES DO NOT WARRANT DECONTROL OF SECTION 104 GAS

It is contended by some that continued regulation of Section 104 gas leads to differences in gas costs between areas of the Nation and that decontrol will level things out.

But, there are differences in cost of coal, oil and electricity from area to area of the country, some of which result from happenstance of location relative to source, but many of which result from different planning on the part of operating companies, both as to timing and method of execution.

This is what happened in the natural gas industry. Some pipelines aggressively built up reserves of Section 104 gas for the benefit of their markets and distribution utilities built up markets on the strength of these dedicated reserves. This is what happened in Illinois, for example. Natural Gas Pipeline Company of America aggressively developed Section 104 supplies, in large part on the basis of advance payments, and utility service in Chicago and other cities in Illinois is predicated on those supplies. Can it be said that Chicago should now suffer a major increase in costs, with accompanying load losses, in order that decreases in cost shall be given by Congress to other areas of the Nation?

That would penalize those who have been foresighted for the benefit of those who were not.

F. ALLEGED MARKET DISORDERS DO NOT WARRANT DECONTROL OF SECTION 104 GAS.

In recent months it has been argued that the existence of a large cushion of Section 104 gas on the system of an interstate pipeline has enabled it to purchase new gas at higher prices and, thereby, freeze-out other competitors for that gas.

There is no evidence that this actually occurred--indeed, such evidence as has been developed is to the contrary. This can be illustrated, again, by the experience of Natural Gas Pipeline Company of America, a supplier of two UDC Members, Peoples Gas in Chicago and Illinois Power in southern Illinois. Despite having a large "cushion" of lower-priced old gas, Natural has not aggressively bid up the price of new supplies. To the contrary, high cost Section 107 today represents less than 1 percent of Natural's gas supplies. Natural's example is typical of many pipelines possessing large old gas cushions. It is clear that those pipelines which bid up gas prices have done so for reasons apart from the presence or absence of a cushion of lower priced old gas.

But, now that average pipeline gas purchase costs have reached market clearing levels, any such opportunity to pay higher prices for new gas has disappeared. Both pipelines with large cushions and pipelines with small cushions must purchase further new supplies in light of the effect which this will have on average cost of purchased gas, which now stands at market clearing levels. In making new purchases today, all pipelines face similar problems, in that none can afford to pay a price which will further escalate its average gas cost. They all stand on an equal footing.

Furthermore, increases in gas prices to date have so curtailed market demands that gas in the field is going begging for purchasers. To contend any longer that cushions of old gas represent a competitive problem becomes ridiculous.

IV.

THE "MARKET OUTS" DESIGNED TO ENABLE DECONTROL RAISE SERIOUS CONSTITUTIONAL PROBLEMS, IMPOSE HORRENDOUS RESTRUCTURING PROBLEMS AND EXPOSE UTILITY SERVICE AND CONSUMER TO GRAVE DANGER

A. INTRODUCTION.

The second key element of the Administration Bill is the "market out" provision in Section 316. This permits any party to an existing contract--whether producer or pipeline--to terminate the contract, in order that it can negotiate new terms or seek another supply or market, as the case may be.

We say this is the second key element because it is an essential adjunct to the decontrol of Section 104 gas. Prices for old gas can rise prior to January 1, 1986 only if contracts are terminated. And, as prices for old gas rise, whether through termination or at January 1, 1986, compensating reductions in prices for new gas must be effected by interstate pipelines through termination and renegotiation--or average gas prices will fly above market clearing levels.

UDC has three major problems with this proposal.

B. CONSTITUTIONAL DANGERS.

It is a foregone conclusion that, when Section 104 producers terminate major contracts, interstate pipelines may want to challenge their right so to do; and it is an even more certain conclusion that, when an interstate pipeline terminates a new gas contract dear to the heart of an independent producer, the independent producer will challenge the legal right of the pipeline so to do.

This litigation will be predicated on the ground that the empowering statute is unconstitutional, and respected legal opinions differ on this point.

There is no question but that Congress has very broad powers over contracts which burden interstate commerce. It can alter prices. It can change terms. It could, if it chose, terminate all of the contracts here involved, on the ground that they burden interstate commerce unduly.

Congress can in all probability grant "market out" or renegotiation rights as to contracts falling within classes which, Congress determines, represent an undue burden on interstate commerce. Contracts for Section 107 gas, or contracts including excessive take-or-pay requirements or contracts embodying unsound price redetermination clauses are obvious examples.

But, in S.615, Congress is being called upon to grant "market out" rights across the board as to all contracts - good and bad - for the primary purpose of deregulating Section 104 gas. This is treading on much more tenuous ground, for which there are no legal precedents.

On this broad and sweeping basis, can Congress authorize a party to a contract to terminate its contract as a matter of its own independent judgment and for its own best interests--whatever they may be--without any right on the part of the other party to demonstrate or have a hearing or other due process?

One can imagine, for example, that a pipeline might terminate a contract for new gas with Producer A, while not terminating a similar contract with Producer B with whom the pipeline is working out another deal.

UDC does not here contend that this broad and sweeping "market out" provision would be unconstitutional and, in any event, our opinion would not decide the matter.

The critical thing is that, if Congress enacts this law and if, in fact, the Supreme Court does hold this provision unconstitutional in 1987 after wholesale reshuffling of contracts, this industry will be in absolute turmoil from which it can never be extricated.

C. AUTHORIZING WHOLESALE "MARKET OUT" AND THEN CASTING THIS INDUSTRY LOOSE OF JANUARY 1, 1986 WITH NO FURTHER PROTECTION FOR UTILITY SERVICE WOULD BE THE HEIGHT OF PUBLIC FOLLY.

In proposing a complete redo of existing supply arrangements for the sole purpose of decontrolling Section 104 gas and then turning the industry loose on January 1, 1986, the Administration necessarily assumes that the whole new set of contractual prices and terms will be just what the doctor ordered for this plagued industry and that, thereafter, all will go forward in conformity with the public interest.

Necessarily, the assumption is that field prices and terms as negotiated by pipelines and producers during 1985 will conform to the demand/price tolerances of utility service, for, in this resource industry, natural gas is produced for sale to the public; and distribution utilities can purchase and receive only what the public will buy.

With utility service now operating in close competition with other fuels and services, there must be a direct and sensitive relationship between consumer tolerances and the prices and terms of field supply and this is what producer-pipeline field arrangements must contemplate and accomplish in the future. Distribution utilities can purchase only what consumers will, in turn, purchase.

The critical question is whether it is reasonable to assume, as the Administration does, that producers and pipelines will, after one year of frantic rearrangement, come up with that completely new hand-tailored set of contracts which will conform to these economic necessities?

Judging from past experience and the temptations presented by both existing law and the Administration proposal, we believe it would be foolhardy for Congress so to conclude.

In essence, as above stated, the Administration Bill envisions that prices for imbedded Section 104 gas will be increased through negotiations between major producers and pipelines and that those same pipelines will then negotiate compensating downward adjustments in prices for new gas. Thousands of contracts are involved; and the pipeline is not endowed, as in the oil industry, with the power to post prices and to make the producer operate in conformity with that posted price. Rather, it must negotiate individually with each producer; and producers--particularly the major producers of Section 104 gas--have tremendous bargaining power.

The Administration Bill attempts to police this contractual reorganization by imposing on the interstate pipelines a PGA limitation ending on January 1, 1986. But, producers and pipelines can agree on easy terms for the year 1985 to save the pipelines harmless from the PGA limitation, coupled with onerous terms commencing in 1986; and, under Section 601 of NGPA, the onerous terms will be thrust through upon the public.

Past experience is clearly a prologue to the future; and, considering the bargaining power of producers, one can readily foresee the following contractual practices emanating from the Administration Bill:

1. Low initial prices for the year 1985, followed by step-ups in 1986, which can thrust pipeline costs further and further above market clearing levels;
2. Indefinite price redetermination clauses of the kinds which almost everyone now considers contrary to all reason and the public interest--for example, clauses pegging the price of natural gas in the field to 110% of No. 2 oil; and

3. Excessive take-or-pay clauses which, at present, are disrupting the natural gas market.

Congress cannot, in good conscience, walk away from these very real probabilities. The natural gas industry has unique organizational and institutional problems which cannot be assumed to disappear just because total decontrol has been placed in effect.

Congress has frequently imposed necessary guides on the free market, as it does under the anti-trust laws. It is both proper and necessary for Congress to impose guides as to take-or-pay clauses and price redetermination clauses.

V

THE TEMPORARY "CONSUMER" PROTECTION PROPOSED IN TITLE I IS BOTH HARMFUL AND ILLUSORY SO FAR AS UTILITY SERVICE IS CONCERNED

Title I to the Administration Bill is wrong for three reasons:

1. it allows costs to continue to rise at the very time when Congress should be taking appropriate action to see that they fall; and
2. insofar as the Administration intends that it shall police the wholesale contract restructuring authorized by Section 316 the provision is illusory; and
3. it leaves utility service and consumers totally unprotected after January 1, 1986, in the face of

past contractual and institutional problems which are obviously against the public interest.

With competitive fuels trending steadily downward and natural gas prices at and above market clearing levels, utility service is desperately in need of price relief in the field. This is the consumer protection which Congress should and must give; and it can readily do so by acting with regard to ceiling prices and by providing means for the reduction of prices in Section 107 contracts.

Title I is illusory and of no value, insofar as the development of new contracts during 1985 is concerned, because--as we have pointed out in the preceding section--it is easy to avoid those constraints; and "all hell can break loose" on January 1, 1986, with absolutely no hindrance from Title I or the Administration.

Title I is of absolutely no protection against those contracts which for one reason or another are not renegotiated and which contain excessive take-or-pay requirements and burdensome price redetermination clauses. For example, a major producer of Section 104 gas having such a contract may choose to ride with the contract until January 1, 1986 when it will be deregulated; and the pipeline purchaser may decide not to terminate for fear of losing the supply. Then on January 1, 1986, the price skyrockets through operation of a price redetermination clause.

Consumer protection is, indeed, desperately needed both short term and long term, and effective means must be taken by Congress to this end.

As set forth in our opening statement, legislation which will place this industry on a sound basis must include:

1. Immediate and effective price relief.
2. Effective action with regard to excessive take-or-pay clauses for high priced gas, and means for correcting these contracts long term.
3. Nullifying unsound price redetermination clauses and providing long term solutions to the problem.
4. Correcting pipeline-distribution relationships so that the market signals of utility service will effectively control prices in the field.

Means to these ends are set forth in the statement of legislative principles attached as Appendix A.

VI

COMMENTS ON S.689 "NATURAL GAS POLICY ACT AMENDMENTS OF 1983."

A. INTRODUCTION.

As set forth in our Opening Statement, UDC applauds the fact that Senator Heinz has introduced a Bill which seeks to deal effectively with numerous pricing, contractual and institutional problems of the industry for the protection of both utility service and consumers.

At the same time, however, UDC respectfully suggests that the Bill leans too far in this direction and that, if enacted, it would have serious consequences from the standpoint of long term supply. Our primary concerns are discussed below.

This is why UDC supports somewhat different principles set forth in Appendix A, believing that they provide sound market principles and protection while still allowing for enhanced supply opportunities in the future.

B. TAKE-OR-PAY CLAUSES.

Section 203 of the Bill would limit take-or-pay requirements in all existing contracts to 50% for the life of the contract. This we believe to be unduly restrictive.

In order to cope with what amounts to a present crisis, UDC does support temporary restriction of take-or-pay requirements in contracts for high cost gas to 50%. But from a long term standpoint, requirements in excess of 50% for some supplies may be both reasonable and in the interest of secured supply. So we propose means through which contractual provisions can be accommodated to reasonable contractual requirements through renegotiation.

C. INDEFINITE PRICE PROVISIONS.

Section 203 of the Bill would outlaw all indefinite price redetermination provisions of every kind, in both existing and future contracts.

UDC wholeheartedly agrees that many of these clauses are a painful burden on the industry, wholly unsound as a means of valuing gas in the field. But to outlaw all such clauses in existing long term contracts while substituting no alternative means of periodically adjusting prices can be wholly unfair to the producer. There should be some sound means of price adjustment in every long term contract for a natural resource.

Furthermore, there are entirely sound types of indefinite price redetermination clauses, and it seems proper from a supply standpoint to allow means of this type to be used -- particularly because proper indefinite price redetermination clauses will cause the price to rise and fall as values change.

Therefore, as set forth in Appendix A, UDC suggests that only those clauses which do not fairly determine moving values in the field be outlawed, and that Congress substitute means for periodic redetermination which will enable prices for gas in the field to rise and fall as the economic forces of the market dictate.

D. PRICE ROLLBACKS AND FREEZES.

Section 202 of the Bill would, as we understand, roll prices in numerous contracts -- primarily those for Section 104 gas -- back to 1978 levels; and, by eliminating the escalation formula in Section 101 of NGPA, freeze prices for many other categories of gas at existing levels. Section 102 and certain other gas would continue to rise at the 4% rate therein provided.

As set forth in Appendix A, UDC supports a rollback of ceiling prices to August 1, 1982 levels in order to take average gas costs to market clearing levels. And we propose that ceiling prices, thereafter, trend up or down in the light of competitive prices. All this is designed to place the market on sound competitive footing and keep it there.

Rolling back Section 104 prices alone appears to UDC to be unfair -- particularly when enforced back to 1978 levels. And a freeze on ceiling prices (coupled with the 4% continuing rise in Section 102 prices) hardly keeps the industry in line with competition.

The urgent necessity is that all ceiling prices be set at proper market clearing levels and that they thereafter trend up or down with competitive forces. The provisions of Section 202, as we understand, do not accomplish these results.

D. PIPELINE ACCOUNTABILITY.

Section 204 of the Bill would amend Section 601 of NGPA by emphasizing the continued effectiveness of Sections 4 and 5 of the Natural Gas Act.

UDC wholeheartedly shares Senator Heinz' desire that legislation dealing with the problems of this industry concern itself with "pipeline accountability." Congress must speak to the point.

As set forth in Appendix A, UDC believes that these necessities can be met through prescription of new pipeline tariff provisions. By reducing minimum bill requirements and giving added market flexibility, there will be imposed on interstate pipelines additional risks sufficient to police the kinds of supply arrangements to which they will commit themselves in the future. And this concept is clearly embodied in the tariff provision of Section 204 of the Bill.

But UDC is concerned that, as written, the subsection dealing with Section 4 and 5 of the Natural Gas Act would, if enacted, prove to be a powerful supply deterent. In point of fact, this principle would empower the Commission to determine the justness and reasonableness of prices for gas in the field; and, while it would have no jurisdiction over producers, its determination would indirectly set what producers could expect to receive from the interstate market. In future periods in which interstate and intrastate purchasers will be vying for gas, there could again arise that very two tier pricing system which, during the 1970's, froze out interstate pipelines in favor of the intrastate market. That was the very situation which precipitated enactment of NGPA.

UDC wholeheartedly agrees that the Federal Energy Regulatory Commission has not, to this point in time, properly construed and applied Section 601 as written; but what is now proposed, we submit, swings too far in the other direction.

Appendix A

UNITED DISTRIBUTION COMPANIES

Statement of Legislative Principles

I

OUTLINE

The following will briefly outline the legislative actions which UDC respectfully believes to be essential:

A. CORRECTIVE ACTIONS WITH REGARD TO FIELD PRICES.

1. NGPA Ceiling Prices - Reduce ceiling prices through the substitution of new formulae which relate ceiling prices to utility market tolerances.
2. Take-or-Pay Clauses - Temporarily limit the level of take-or-pay requirements on higher cost gas; and provide long term solutions to the contractual problem.
3. Indefinite Price Redetermination Clauses - Outlaw the most unrealistic of such pricing clauses in deregulated contracts; and provide substitute means for periodic redeterminations.
4. Existing Contracts for Section 107 and Other High Cost Gas - Provide for the renegotiation or termination of these contracts.

B. CORRECTIVE ACTIONS WITH REGARD TO PIPELINE TARIFFS.

1. Establish comprehensive and expedited processes for the consideration and implementation of new tariff provisions governing the pipeline-distribution utility relationship, to the end that the dictates of the ultimate market shall play their essential role in governing prices for field supply.

C. PROVISIONS WITH REGARD TO DECONTROL.

1. Postpone decontrol now envisioned by Section 121 of NGPA until the essential new pipeline tariff requirements shall have been placed in effect, a period which should require about 24 months from date of enactment.
2. Confirm NGPA policy for continued regulation of "old" gas.
3. Eliminate the Commission's NGPA authority to increase prices.

D. PROVISIONS WITH REGARD TO IMPORTS.

1. Take such action as may be proper to limit costs of imported gas to levels determined by marketability in this country.

E. PROVISIONS WITH REGARD TO MARKET RESTRAINTS.

1. Title II of NGPA (incremental pricing) and the Fuel Use Act should be repealed.

February 16, 1983

II
INTRODUCTION

For many years the natural gas industry was plagued by problems arising from underpricing of field supplies due to Federal regulation, with consequent excesses in demand and shortages in supply.

Now, as the industry moves toward ultimate decontrol in accordance with NGPA, critical problems of an entirely different kind have come into being and threaten the industry with devastation of a different character. In essence, all of these problems are reflected in the simple fact that field prices for gas are not responding to the demand and price dictates and tolerances of the ultimate market. Field prices for gas are steadily rising in a time of excess supply and are being pushed further and further above marketable levels. This is contrary to all reason, for declining market demands in a time of adequate supply dictate that field prices should fall.

The causes of this explosive situation are all found in established contractual and institutional practices, nearly all of which emanated from the shortage situation of prior years. The only way in which the industry can be put on a sound economic track toward ultimate decontrol is through three basic kinds of action:

1. Correction of pricing excesses which are resulting, and will result, from outstanding contracts;
2. Prescription of certain new contractual requirements for the future; and
3. Establishment of new pipeline tariff practices which will cause pipelines to operate in sound contractual fashion in the future and cause their supply operations to conform to and be accountable to the dictates, limitations and tolerances of the ultimate market.

In net effect, the proposals hereinafter made by UDC will bring about an immediate reduction in retail prices, by bringing field prices into line with the market, and an accompanying increase in consumer demand for gas. They offer reasonable prospect for stable retail prices for several years and a sounder gas industry.

* * * * * * * * *

Inquiries

Inquiries with regard to this Statament of Legislative Principles may be made to one of the following UDC representatives:

C. William Cooper, Chairman of UDC (617-540-0330);
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III

CORRECTIVE ACTION WHICH MUST BE TAKEN WITH REGARD TO PRICES AND CONTRACTUAL REQUIREMENTS FOR FIRST SALES OF NATURAL GAS IN THE FIELD

A. BRING NGPA CEILING PRICES INTO LINE WITH MARKET REALITIES.

As construed by the Commission, most producer-pipeline contracts for field supply cause prices to track the ceiling prices embodied in NGPA. And, since NGPA embodies formulae which steadily escalate ceiling prices in ways which bear no relation to the course of competitive fuel prices, field prices are likewise rising in ways which bear no relation to changes in market value.

In consequence, average costs of purchased gas have been propelled to and above market clearing levels. The only prospect in sight is that this disastrous upward path will inexorably continue, with consequent choking off of utility loads and disruption of utility service.

All this is contrary to sound economic principles. In today's supply and competitive environments, prices for these supplies should be far, far lower, and also trending downward.

In the public interest, Congress should provide as follows:

1. that ceiling prices for the several NGPA classes of gas shall be reduced at date of enactment to the level of ceiling prices in effect on August 1, 1982, and

2. that ceiling prices as so adjusted at date of enactment shall, thereafter, be adjusted--either up or down--in accordance with changes in the value of gas to the utility market--again as indicated by changes in the cost of competitive fuels faced by that market; provided, however, that, if in any year competitive fuel prices rise at a rate greater than general prices in the economy, as measured by the Implicit Price Deflators, then gas ceiling prices shall be adjusted, in that year, by the lesser rate so indicated by the general economy. This limitation will guard against too great an increase in gas prices in the event of a sudden surge in competitive fuel prices.

These principles should bring pipeline average costs into line with levels dictated by the demand and price limitations of utility service and maintain the same in that general posture, pending ultimate decontrol.

The ceiling price adjustments required by the above rules should be calculated by the Energy Information Agency. The adjustments required by subparagraph 2 should be determined and made once each year.

B. TAKE-OR-PAY CLAUSES IN PRODUCER-PIPELINE CONTRACTS.

Excessive take-or-pay requirements in producer-pipeline contracts for Section 102 and other high cost gas are causing inefficient and unsound supply operations. They inflate average costs of gas unreasonably and unnecessarily; and these harmful effects are most pronounced during periods of supply surplus and depressed market demand--such as are now being experienced and expected. The financial and operating consequences are serious and critical; and corrective action must be taken in the public interest.

To achieve emergency relief, coupled with long term correction, Congress should provide as follows:

1. Take-or-pay requirements in all existing and future contracts for first sales of Section 102 gas and deregulated or other high cost gas shall be capped at 50% of daily deliverability for a period of three years following date of enactment.

   As to all contracts so limited, the pipeline shall have the right to require renegotiation of the take-or-pay requirements either before or after the expiration of said three year period, with accompanying right to terminate if the negotiations fail of agreement. If so terminated, the pipeline shall have a right of first refusal if the producer proposes to sell the supply to another purchaser. If the contract is so terminated and the gas is sold to another purchaser, the terminating pipeline shall, to the extent possible, arrange transportation for the producer's supply to another pipeline.

2. In both new and renegotiated contracts not covered by the foregoing paragraph, pipelines shall be responsible for arranging contractual supplies with such flexibility, varied mix and protective contractual rights that excess supply situations can be handled efficiently and economically and without undue prepaid costs. In particular, to insure sound contractual practices on the part of interstate pipelines, the Commission shall, in its rate regulation, review pipeline gas supply planning and contracting as a condition to the full recovery of carrying charges associated with prepaid gas costs.

C. INDEFINITE PRICE REDETERMINATION CLAUSES APPLYING TO FIRST SALES OF DEREGULATED GAS.

Indefinite price redetermination and favored nation clauses in producer-pipeline contracts will inexorably force deregulated gas prices far above market clearing levels, with inordinate and destructive injury to utility service and the consuming public.

In the public interest, Congress should provide as follows:

1. Nullify and outlaw indefinite price redetermination clauses which are unsound and contrary to the public interest because they do not determine the value of gas in the field.

The price or value of deregulated gas in the field must be determined by the demands and pricing tolerances of utility service. Yet, indefinite price redetermination clauses currently in use embody formulae or mechanisms which bear no direct or rational relationship to such value and will cause field prices to fly far above that value. And, they always escalate prices upward, whereas values of gas in the field must rise or fall depending on supply and demand.

Whether embodied in existing contracts or in new or renegotiated contracts made in the future, any indefinite price redetermination clauses of these kinds will cause irreparable harm to utility service and they are and will be an unconscionable burden on interstate commerce.

In the public interest, Congress should nullify and outlaw, in both existing and future contracts for first sales of deregulated gas, the following indefinite price redetermination clauses:

a. "favored nation" clauses, both two party and third party, which cause prices to be equated to a limited number of high or "highest" prices in other contracts--the results being in no way representative of market value;

b. "commodity" clauses, which cause the price of gas in the field to be equated to the market price, or a specified percentage of the price, of another fuel, such as No. 2 oil--the result being in no way representative of the market value of another natural resource in the field;

c. "inflation index" clauses, which trend the price of gas with changes in the CPI or other general price indices--changes in general price levels normally not being indicative of changes in the value of natural gas for the utility market for which it is destined--for example, prices in general are rising at this time, whereas prices in the field should be dropping;

d. imported gas price clauses, which cause the field price of domestic gas to be equated with the price of foreign gas as delivered through a transportation system to an international border; and

e. generally, any other clauses which cause the price of gas in the field to be equated to, or trended with, prices which do not reasonably or rationally indicate market values of gas in the field or changes in that value.

2. Provide new means for periodic indefinite redetermination of deregulated prices in contracts existing on date of enactment.

In existing contracts, a sound means of periodic redetermination must be substituted for nullified clauses and Congress should provide as follows:

a. that, both the producer and the pipeline shall, each, have the right to require renegotiation of price at stated intervals, and that, as so renegotiated, the price shall supplant the old;

b. that if, after a period for renegotiation, the parties shall have failed to agree upon a new price, the contract may be terminated by the dissatisfied party, whether pipeline or producer;

c. that, if the contract is terminated, the producer may seek another pipeline purchaser for the subject gas; but, the pipeline which has been a party to the terminated contract shall have the right of first refusal of the gas at the price tendered to the producer by such other pipeline purchaser; and

d. that, if any contract is so terminated by a producer and the right of refusal is not exercised, the pipeline shall, to the extent possible, arrange transportation for the producer's supply to the new pipeline purchaser.

3. Certain standards for future contracts.

It is essential to the sound operation of the industry that problems occasioned by past contractual practices not be repeated. To this end, Congress should provide that each new or renegotiated first sale contract made following date of enactment shall conform to the following standards:

a. that both pipeline and producer shall each have the right to require redetermination at the same stated intervals;

b. that redetermination of prices must be based on either renegotiations between the parties or other means which fairly achieve the current value of gas in the field for the market for which the supply is destined, it being contemplated that prices can move either up or down as values change over time; and

c. that none of the above nullified and outlawed may be incorporated in the contract.

D. REDUCTION OF ABNORMAL AND EXCESSIVE PRICES IN FIRST SALE CONTRACTS FOR SECTION 107 AND OTHER HIGH PRICED GAS.

The abnormal market in existence since NGPA was enacted has spawned a host of abnormal and excessive prices for deregulated Section 107 and other high priced gas. These bear no rational relationship to market clearing levels; and the same would not have been made by interstate pipelines in the light of today's conditions. The intense burden on interstate commerce arises from the fact that the contracts contain no means of correction to current market conditions.

The contracts as stated are an unconscionable burden on interstate commerce; and Congress should provide for their adjustment and correction in the following manner:

1. that, both the producer and the pipeline shall, each, have the right to require renegotiation of the price, and that, as so renegotiated, the price shall supplant the old;
2. that if, after a period for renegotiation, the parties shall have failed to agree upon a new price, the contract may be terminated by the dissatisfied party, whether pipeline or producer;
3. that, if the contract is terminated, the producer may seek another pipeline purchaser for the subject gas; but, the pipeline which has been a party to the terminated contract shall have the right of first refusal of the gas at the price tendered to the producer by such other pipeline purchaser; and
4. that, if any contract is so terminated by a producer and the right of refusal is not exercised, the pipeline shall, to the extent possible, arrange transportation for the producer's supply to the new pipeline purchaser.

IV
CORRECTIVE ACTION WHICH MUST BE TAKEN WITH REGARD TO TERMS ON WHICH GAS IS SOLD BY INTERSTATE PIPELINES TO DISTRIBUTION UTILITIES

A. THE PROBLEM STATED.

As pricing crises in the industry have mounted in recent months, it has become evident that, in many instances, archaic forms of rate design embodied in pipeline tariffs have been a major factor in bringing them about. This is because the rate designs on which pipelines have been rendering service to distribution utilities have, in effect, deluded pipelines as to the marketability of gas to distribution utilities and have, thus, failed to impress upon pipelines, and in turn producers, the necessity for tuning field prices and operations to limitations imposed by the ultimate market.

This is a problem which was neither considered nor envisioned when NGPA was enacted, because at that point in time, natural gas was seriously underpriced and consumers were clamoring for supply. Forms of pipeline tariff hardly mattered.

But now distribution utilities are literally choking on gas which is tendered at high prices under existing tariffs and which consumers will not buy. And, it is obvious that such tariffs have not been, and are not, performing their proper function.

The quantities of service which consumers will take at given price levels necessarily determine the supply and price limitations which distribution utilities must, in turn, impose on pipelines. Utilities cannot be forced to take gas which they cannot sell. And yet, that is exactly the effect which many rate designs now have, and will have with growing intensity, as field prices continue to rise and consumer uses continue to decline.

Rather, in this, as in any natural resource industry, pipeline tariffs must be tuned to the principle that the value of any given level of supply in the field depends on the marketability of that supply. Tariffs must provide to utilities those flexibilities which bring to bear on prices in the field those economic limitations which are imposed upon utility service by the ultimate user.

In this new era in which marketability must play a direct and all-important role in the establishment of prices and volumetric requirements in producer-pipeline contracts, it is clear that a pipeline tariff must embody the following characteristics:

1. As a general rule, volumetric requirements imposed by a pipeline tariff must respect and be limited by the requirements of utility service, for distribution utilities can only take what they can in turn market on an efficient and economical basis in meeting consumer demands. And, as a general rule, pipelines must, in turn, arrange their various supplies with such mix and

flexibility as will accommodate this marketing situation. Operations in the field must respect the demand/price tolerances of utility service and the market signals so conveyed. Take requirements in producer-pipeline tariffs must be designed according to distribution utility load factors or individual committments.

2. Pipeline rates must be such that gas taken is marketable by distribution utilities; and, to this end, the tariff must be so organized and designed that the varying demands and pricing limitations of the ultimate market bring leverage on the pipeline to secure and manage its field supply in an economic, flexible, efficient and marketable fashion. In this sense, the pipeline must be accountable to distribution utilities and ultimate users.

3. Fundamentally, the risk of loss due to non-marketability must be that of the producer. The pipeline operates on a cost of service basis; and so long as it operates and arranges its supply in sound fashion, it should recover its fixed and other costs of operating its pipeline facilities. It is in this sense that distribution utilities and consumers are accountable to the pipeline for the costs of operating its system.

4. Thus, in essence, pipeline rates must be designed with such volumetric flexibility and discretion on the part of distribution utilities that the limitations and pricing dictates of utility service shall be given effect in costs and arrangements for field supply; but, at the same time, with responsibility on the part of distribution utilities to bear appropriate portions of the legitimate and prudent costs of operating the pipeline system in meeting service obligations.

B. ESSENTIAL CONGRESSIONAL ACTION.

Problems with existing tariffs have come to the forefront of distribution utility concern; and they obviously require reevaluation and correction in light of the new economic era in which the industry is and will be operating.

Considering the importance of the problem, time is of the essence. Yet, normal ratemaking process is opposed to prompt and concerted action. The Commission is attempting to deal with the situation as it must through processes which do not admit of policy guidance, which can take years for solution and which can eventuate in a crazy quilt of conflicting principles, not suited to competitive and in-tandem pipeline operations.

It is not desirable that Congress attempt to legislate specific rate designs or tariff principles. It is essential, however, that Congress establish new processes which will enable the Commission to cope with this critical industry-wide problem in an efficient and timely fashion.

To this end, Congress should authorize and direct the Commission to proceed in the following manner:

1. that the Commission shall, with all due dispatch, conduct comprehansive rulemaking hearings designed to develop a broad statement of those rate design principles which will foster and insure that gas supply and field prices respond as market signals are transmitted to pipelines and producers;
2. that the Commission shall promulgate its statement of rate design principles within 12 months following date of enactment;
3. that the Commission's said statement as so promulgated shall be reported to Congress when issued, accompanied by a full report;
4. that, unless modified by further Congressional action, the Commission shall then promptly commence proceedings as to each individual pipeline for the purpose of determining the extent to which the existing tariff of the pipeline shall be modified in light of said statement of principle, and, if it so finds and determines, it shall promulgate such new rate design or designs for such pipeline as it does find to be just, reasonable and required by the public interest; and
5. that the Commission shall make every effort to complete the said pipeline rate proceedings within 24 months following date of enactment, but, in any event, prior to January 1, 1987.

V

PROVISIONS WITH REGARD TO DECONTROL

A. POSTPONEMENT OF DECONTROL OF NEW GAS UNTIL ESSENTIAL NEW PIPELINE RATE DESIGNS TAKE EFFECT.

New pipeline rate designs are critical to the successful marketing of gas in close competition with other fuels, and until the same take effect, there is no assurance that field supply operations and prices will conform to the necessities and dictates of the ultimate market.

To see that the public interest is protected, Congress should delay decontrol of "new" gas until necessary rate design changes occur; and, to this end, it should provide as follows:

> that Section 121 of NGPA is amended by changing the decontrol date of January 1, 1985, to that later date on which the above required rate design proceedings are completed and new tariff provisions take effect, but not, however, beyond January 1, 1987.

B. MAINTENANCE OF CEILINGS ON OLD GAS.

The new statute should reaffirm the policy of NGPA that ceiling price controls on "old" gas--i.e., primarily pre-NGPA gas covered by Section 104--shall continue indefinitely. This is necessary for the following basic reasons:

Decontrol of old gas must have as its intent and purpose an equalization of prices for all classes of gas, just as posted prices for crude oil are generally uniform, regardless of the age of the well.

But with average gas purchase costs of pipelines now standing at or above market clearing levels, equalization could be accomplished only through the roll back of prices for new gas. But this flies in the face of both economic realities and producer expectations.

Old gas was drilled for and brought on line when costs were much lower and when producers were fully aware that their prices would be regulated. Also, it was often lower-risk gas, because projects were funded by pipelines and their customers through advance payments. New gas, on the other hand, has been drilled for in times of higher costs and brought to market only on the strength of higher prices and in the expectation of ultimate decontrol.

UDC impact studies show that raising prices for old gas to market clearing levels would depreciate prices which could be paid for future reserves to such low levels that future exploration and development would be frustrated, raising the prospect of shortages developing in the not too distant future.

C. RESTRICT THE COMMISSION'S NGPA AUTHORITY TO INCREASE PRICES.

With average gas purchased costs of pipelines now being pushed further and further above market clearing levels, this is no time for the Commission to establish "incentive" prices for high cost gas pursuant to Section 107 or increase prices for old gas pursuant to Section 104, as has been proposed in various pending dockets. Distribution utilities are already choking on existing supplies at existing prices and more incentives cannot be tolerated.

Sometime in the future when conditions change and shortages occur, Commission actions pursuant to these authorities may become essential. But, all such Commission actions should be laid to rest until the existing crises in the market are corrected and until the current surpluses in deliverability disappear.

To this end, Congress should withdraw the ratemaking authorities of the Commission under Sections 104 and 107 until further action by Congress at some point in the future.

VI
PROBLEMS WITH REGARD TO IMPORTS

Prices being paid by pipelines for gas being imported into the United States are, in many cases, causing severe marketing problems. And, furthermore, the excessive prices paid for these supplies directly depreciate the level of those prices which can be paid in future for new reserves of domestic supply.

While it is recognized that important international relations are involved, it is recommended that Congress take such action as may be appropriate to encourage amelioration of these prices.

VII
ELIMINATION OF DEMAND CONSTRAINTS

Any new natural gas legislation should eliminate the demand constraints imposed or envisioned by the incremental pricing provisions embodied in Title II of NGPA and in the Fuel Use Act of 1978.

The CHAIRMAN. Mr. Rodemann.

STATEMENT OF U. WALTER RODEMANN, GENERAL MANAGER, WATER, GAS & LIGHT COMMISSION, ALBANY, GA.

Mr. RODEMANN. Mr. Chairman, I understand the statement submitted is part of the record anyway?

The CHAIRMAN. It is.

Mr. RODEMANN. So, I will not abuse your time, and just speak freely.

As the General Manager of a small natural gas system, consisting of about 18,000 residential customers—about 1,900 general service, general commercial customers, and 21 industrials, Mr. Chairman, I submit that we in the trenches, we are the midget in this room, but we are fighting the gas war in the trenches.

We are extending the bills, and we are making arrangements to the old lady or underprivileged, and we fight this battle every day.

The bill introduced by you, sir—sometimes referred to it, as the administration bill, is a very good start. The problem right now is, as it already was stated earlier, the significant loss of industrial load, befalls a larger burden of cost to the residential customers; and this is really the problem, and that is what I am talking about the subject here, right now.

I hear some remarks made about comparison with No. 6 fuel. Mr. Chairman, I submit to you, this is not the only danger. There is a possibility that oil prices will drop to $20 later this year. If this happens, then the natural gas that we are selling on the local level will not only compete with No. 6, but will have to compete with No. 2.

This would mean a complete collapse of the natural gas market as we know it.

It must be realized that, through regulation, the natural gas industry, per se, had been protected; it has been protected many, many years. Yes, there were shortages, but the gas companies, the interstate pipeline companies always could get relief—by FERC because there was a shortage.

Now, a short time ago, the interstate pipeline companies had relief because the ultimate supplies were predicted to be short; but if nothing else happened, NGPA has stimulated the drilling and the exploration, but it has also served its purpose.

We are now faced with a situation where the free enterprise system must come more into play. And again the key point is, the industrial market supports the residential customer—the end user, and that is our main concern.

Specifically, I will say this. I am in favor of deregulating old gas. Sir, I submit to you, you wouldn't sell an ounce of gold at $35; and I don't know of any legislation that would take old coal, or old yellow cake—these things are being sold in the open market within restrictions—there are some, I am sure.

So, I believe—and I have to trust in the enterprising spirit of the businessmen to make a profit. Yes, sometimes profit is called a dirty word, but profit really makes this country run.

I am in support of limiting the Fuel Use Act for obvious reasons. It reduces the market in an artificial way, and it already has been stated that incremental pricing is a fluke of legislation.

As a man fighting in the trenches, I have other proposals. And I believe Congress should sincerely address those questions. The regulatory process in FERC must be speeded up, because the signals of the marketplace are sometimes lost in the paper shuffle that may take several years.

I also want to propose that the cost of rate filing should fall to the part filing for higher rates, and it should not be borne by the ultimate user of the gas.

The ultimate user of gas has to defend those increases and bear that cost to begin with, and if that is a new scheme, so be it; the time is now to do something fresh, and the gas companies, the producers, interstate pipeline companies, and intrastate—they must have the guts to come up with innovative ratemaking to secure the market in the future.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Rodemann follows:]

STATEMENT OF U. WALTER RODEMANN,
GENERAL MANAGER
WATER, GAS & LIGHT COMMISSION, ALBANY, GEORGIA

I am U. Walter Rodemann, General Manager of the Water, Gas & Light Commission, Albany, Georgia, and have occupied that position for twelve years. Prior to that time I was manager of the gas department and have generally been involved with one aspect or another in gas utilities for the last 25 years.

The Water, Gas & Light Commission (Commission) provides major utility service for the metropolitan area of Dougherty County, Georgia. We have been in the gas distribution business since September of 1955; and currently serve some 18,000 residential customers, 1900 general service customers and 21 industrial customers. The sole supplier of natural gas to the Commission is South Georgia Natural Gas Company, Thomasville, Georgia, a wholly owned subsidiary of Southern Natural Gas Company, Birmingham, Alabama.

At the present time the Commission is the single largest customer of South Georgia Natural Gas Company, both as to its jurisdictional and nonjurisdictional gas sales. In addition to South Georgia Natural Gas purchases, the Commission maintains its own propane-air peak shaving plant and is a participant in a natural gas storage project located in the state of Michigan. Gas from the storage project and the peak shaving facility is used by the Commission to supplement its supplies on days of reduced natural gas deliveries from South Georgia Natural Gas Company.

The Commission's industrial customers are all interruptibles, that is, they receive gas only when available. However, these industrial customers represent approximately 70% of the Commission's total yearly sales and are an important component in system operation. In recent years, the system has been operating under severe curtailment because of a shortage of natural gas.

Currently the system is under a 12,000 mcf a day contract with South Georgia Natural Gas although actual annual deliveries have exceeded that contract demand figure. The system's total annual sales for the year 1982 for all classes of customers amounted to 4,294,005 mcf.

The Commission's gas operation is that of a typical southern distributor. That is, its primary function and design is to provide winter heating capability to residential, institutional and small commercial customers. The industrial gas load levelizes annual sales and thereby stabilizes cost and retail rates. In other words, the system has been built around the concept of a firm heating load during winter months and interruptible industrial deliveries during the warm months.

In recent years, especially subsequent to the oil embargo of 1973 and the Natural Gas Policy Act of 1978, there has been an escalating cost of gas so as to frustrate the balance of operation between firm residential heating load and industrial interruptibles. This has not only affected the sales of the Commission but, more importantly, it has affected its ability to attract, keep, and compete for industrial load. The high price of natural gas has created a direct competition with high sulphur No. 6 fuel oil, among others, as an alternate source of energy. Fuel switching by industrials has become a fact of life under the current high cost of natural gas.

On our system alone there have been four major industrial customers who have either switched to alternate fuel supplies or have installed the capacity to do so, using it as prices fluctuate. This has had a dramatic effect on the Commission's operations because the reduction of sales has necessitated shifting a greater burden of cost to the residential load. Currently natural gas sold by the Commission is competing not only with No. 6 fuel oil but wood chips and coal; and if oil prices continue to decline, there is a real possibility that we will lose our competitive edge with No. 2 fuel oil. The ever increasing price of the gas has caused great concern among industrial customers.

Since the early seventies, the Commission has tried in several different ways to guarantee gas supply even in the face of dwindling reserves. Large expenditures have been made not only with the propane peaking facilities and gas storage, but the Commission has also participated in a LNG project sponsored by Southern Natural Gas Company. To encourage the installation of a LNG facility at Elba Island, Georgia, the Commission agreed to accept additional quantities of higher priced gas from this facility. The LNG project is now at a standstill due to foreign politics but it has nevertheless been an expensive undertaking to this Commission. The funds that have been expended by this Commission are nonrecoverable and we have received no credit or price recognition for them in the wholesale cost of natural gas. The point being that this Commission, and other similarly situated distributors, through the ongoing progress just mentioned, have enabled natural gas suppliers to remain afloat during critical years of gas shortage.

The continuing paradox of increased gas cost leading to reduced sales, which in turn leads to higher cost per unit of gas is a seemingly endless spiral of frustration. Any approach to the current gas supply situation must obviously deal with the end users ability to afford natural gas.

The Natural Gas Policy Act of 1978 encouraged exploration for new gas and there has indeed been significant additions to proven reserves. Unfortunately that Act offered very little consumer protection as to price increases. The problem seems to be that the encouragement of exploration to find new reserves has resulted in the escalation of cost on unregulated gas. The effect in the market place has not only been unrealistic but in my opinion disastrous from the standpoint of the average gas customer.

Having recognized the effects and benefits of the Act of 1978 which have lead into the present oversupply situation, any correction in policy should not overreact and create the opposite result. In other words, we cannot afford to hastily consider a midcourse correction which will destroy reliability of service for the future. The balance must be found between the incentive to explore and produce while meeting price demands in the market place to insure that the natural gas companies continue to supply this form of energy.

I have read not only Senate Bill S.615 but also the President's recommendation concerning this legislation. The Bill will obviously invite different positions from intrastate and interstate pipeline companies as well as distributors. However, it is my firm belief that there must be an agreement by all parties which will satisfy all sections of the industry. Therefore, the initial steps taken by President Reagan and Senator McClure are certainly commendable. I would like to make a few observations about certain features of the Bill which I am most concerned with:

1. I am concerned about the 70% ceiling proposed on "take or pay" contracts. I have been involved in several proceedings before FERC in the last several months that lead me to

believe this is not a realistic figure. I think it should be reduced to at least 30%. On my system alone, the present actual impact of "take or pay" contracts from my supplier amounts to approximately 25¢ per mcf. This is a substantial increase in the cost of gas that is directly related to "take or pay" contracts.

2. A definite mechanism is needed to allow better marketing of so-called old gas. It is no longer realistic to maintain a regulated ceiling on this gas because the producers are simply not putting it in the stream of commerce under the present pricing system.
3. I wholeheartedly endorse the elimination of the Fuel Use Act and incremental pricing. The present availability of gas dictates the necessity to open up new markets and to encourage the reopening of old markets that this Act effectively closed. The Fuel Use Act no longer serves any realistic purpose in view of the tremendous new reserves that have been located and established.
4. Of continuing concern to me as a distributor is the timely and costly proceeding with regard to gas rates. I feel that Congress should

definitely look to the implementation of an expeditious manner in handling gas rate cases. Under the present procedural rules, market signals are often lost due to time consuming administrative hearings.

5. Under current gas rate rules, producers and pipelines are able to pass through to customers the entire cost of rate proceedings on the theory that they represent a justifiable cost in the rate base. Why not make the shareholders of the producers and interstate pipeline companies absorb this cost rather than passing it on to consumers. Such a move would certainly affect the length and frequency of regulatory hearings. I realize that this would be a radical departure from rate based techniques but if the industry is going to survive there are going to have to be some radical changes.

6. The Act proposes a mechanism which would mandate the transportation of gas for others (wheeling) by pipeline companies. I am heartily in favor of this provision and I think it would greatly aid in establishing a freer market place. I recently attended a meeting with some twenty municipalities in Memphis, Tennessee concerning the possibility

of acquiring gas reserves for future use through the mechanism of a joint action group. The biggest single problem with this arrangement is the lack of transportation rights under current regulations. Requiring pipelines to wheel gas, subject to capacity availability, would be a major step in that direction.

I am sure that there are other provisions in the Bill which are equally important, but these represent the ones that I am personally conversant with and feel a great deal of concern about. Everyone recognizes we have a problem in the gas industry; it is now only a question of finding a timely and proper solution. The incentive for establishing new reserves of gas is profit and I realize that must be protected. However, gas reserves without a market mean nothing. From my vantage point as a distribution system manager, I am concerned about economic ability to continue to serve residential heating loads at acceptable cost without the opportunity to compete for interruptible industrial loads.

Whatever comes from the Congressional investigation of the current gas problem, there must be an awareness that without a competitive product on the industrial side of the ledger, gas distribution systems such as mine cannot hope to provide the level of service to the traditional firm customers.

The CHAIRMAN. Mr. McGrath.

STATEMENT OF JEROME J. McGRATH, PRESIDENT, INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA

Mr. MCGRATH. Thank you, Mr. Chairman.

I am president of the Interstate Natural Gas Association of America, which represents the interstate natural gas transmission industry.

I would first like to say that we view the administration's proposal as a positive sign, and we applaud the President and the chairman for introducing this legislation.

However, I would say that S. 615 contains many serious flaws, and we cannot support it in its present form.

The record has been replete so far with descriptions of the critical market situation that the industry is facing, and in the interest of time, I will not recite further about the difficulties that we have. They are many, and our concern is that the Congress move fast, this year, to pass legislation which will truly address these problems.

In that regard, I would like to make some brief comments before commenting on the administration's bill.

On INGAA's legislative proposal which we believe addresses these critical issues, and I would like to do it, if I may, Mr. Chairman, with some specificity.

We would recommend that new new gas not be subject to the provisions of the Natural Gas Policy Act on and after a date certain—say, a date of enactment.

At the present time, there is a surplus in deliverability in the United States of natural gas. We estimate that in 1982 on our companies it amounts to approximately 2 trillion cubic feet.

With such a surplus in the country today, we think there is a strong indication that decontrolling new gas could lead to gas prices lower than those likely under the NGPA as it presently stands.

Second, we would recommend the adoption of a price cap to diffuse indefinite price escalator clauses. All contracts in effect prior to the effective date of the legislation—except contracts for 107 gas containing indefinite price escalator clauses or area rate clauses would be capped at the lower of the contract price, or the market reference price.

Now, the market reference price would be determined on the basis of the national weighted average price paid for new new gas, by all pipeline companies during the 3 most calendar months which data are available.

The capping mechanism would remain in effect until the contracts containing IPE clauses or area rate clauses are renegotiated or amended.

We propose a reduction in maximum take-or-pay amounts in existing contracts for gas-well gas to 50 percent of deliverability for a period of 3 years from the effective date of the legislation, with the right of makeup for prepayment above the 50 percent until fully recovered.

Now, while not all of our companies are caught in take-or-pay, many of our companies are, and it is our best estimate that a rollback to the 50 percent level is needed to achieve significant relief.

Additionally, we believe reductions and required takes will have a beneficial impact on price, and I have covered this very extensively in my testimony.

Provisions should also be made to allow either party to a contract for section 107 high-cost gas the discretion to terminate that contract within 1 year from the effective date of the legislation.

If the contract is terminated, the purchaser would be given the opportunity to exercise a right of first refusal and if the right is not exercised, it would be required to transport the gas for the seller under terms and conditions determined by the FERC.

And we would also recommend the imposition of a limitation on the passthrough of purchased gas costs for gas purchased under contracts, the recovery of those costs via the PGA mechanism should be excluded to the extent that such costs exceed 110 percent of the price cap.

And we would also recommend that the NGPA 4 percent kicker that automatically increases the ceiling price for sections 102 and 108 gas each month above inflation should be repealed immediately.

This proposal, we believe, would restrain the upward pressure on prices reflected in PGA filings of the pipelines; and, as noted previously, the gas cap we recommend, we believe, will have a leveling effect on the natural gas pricing.

We would also recommend amendment of the Fuel Use Act, and repeal of title II of the NGPA.

Now, with respect to the administration's bill, we take exception to the proposal that would restrict the PGA passthroughs as proposed.

In our view this provision will adversely affect, and dramatically affect all of the interstate pipelines. Ironically, the pipelines with the lowest purchased gas costs would be affected most severely.

The basic unfairness of section 101 of S. 615 is clearly shown by the deep disparity between the allowed rate for purchased gas for low-cost pipelines compared to high-cost pipelines.

As can be seen from table 3 in my testimony and attachment A, the administration's bill would put the pipelines with the lowest average cost of purchased gas at a distinct disadvantage to the higher cost pipelines.

The end result will inevitably be that the pipelines which have achieved the lowest cost will have little opportunity to buy new gas supplies in competition with other interstate pipelines or with intrastate pipelines.

As a matter of fact, both high- and low-cost interstate pipelines will be severely inhibited in acquiring new reserves in competition with the intrastate pipelines. In our view, you will be heading right back to the dual market that we were addressing and which the Congress addressed in 1977 and 1978, when it established the NGPA, when it eliminated the dual market between the intrastate and interstate.

The bill would also place stringent and irrational and unworkable restrictions on the purchase by pipelines of gas from affiliates or pipeline-owned production.

There is no practical way to implement it short of banning pipeline-owned production and affiliate production. We believe it is blatantly discriminatory against pipeline companies with such production.

INGAA is opposed to the proposal in the administration's bill to decontrol forever regulated, or old gas. Decontrol of old gas as proposed could cause substantial price increases on pipeline systems with large quantities of gas. The 70 percent limitation on take-or-pay—and the bill is too high, as I mentioned—50 percent, we believe is a more appropriate level to use.

We do not oppose the access of intrastate pipelines to natural gas provided that the access is equal, and by that I mean they do it on the same terms and conditions that the interstates are required to acquire gas in the interstate market.

In S. 615, the intrastate pipelines are given a distinct advantage over interstate, and that is only in competing for natural gas, but in having it moved in the interstate market without being subject to the jurisdiction of FERC, and we believe that is not fair and will serve again to exacerbate the problem of gas acquisition for the interstate pipelines in competition with the intrastate buyers.

With respect to the transportation provisions of the bill requiring interstate pipelines to move gas, the language of the bill is very vague. There are provisions in it which are—such as the incentive rate which would make it more attractive for interstate pipelines and, as is presently casted, we could not support that provision.

In conclusion with respect to your bill, Mr. Heinz, we really haven't had a chance to analyze it. There are some features in it that look pretty good; there are also some features in it that are very adverse according to the interstate pipelines.

In conclusion I would like to reiterate that we, the interstate pipelines, feel that natural gas legislation, a comprehensive bill to address our many problems is imperative if we are to get into a situation where we can market the gas and the distributors can sell it in competition with oil and other fuels.

Thank you.

Senator HEINZ [presiding]. Thank you very much, Mr. McGrath.

[The prepared statement of Mr. McGrath follows:]

STATEMENT OF JEROME J. MCGRATH, PRESIDENT
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

MARCH 11, 1983

Mr. Chairman and Members of the Committee:

My name is Jerome J. McGrath. I am President of the Interstate Natural Gas Association of America (INGAA), a national trade association whose membership is comprised of virtually all of the major interstate natural gas transmission companies operating in the United States.

INGAA member companies account for over 90 percent of all natural gas transported and sold in interstate commerce. All of our member companies are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC) as mandated by the provisions of the Natural Gas Act (15 U.S.C. 717, et seq.) (NGA) and the Natural Gas Policy Act (15 U.S.C. 3301, et seq.) (NGPA).

I am pleased to appear before the Committee today. INGAA has long believed that Congressional action is needed to resolve the very real problems facing the natural gas industry and our consumers. We sincerely hope that this series of hearings marks the first step toward passage of natural gas legislation in 1983.

We congratulate the Administration for recognizing the need for comprehensive natural gas legislation to alleviate the current market disorders. The decision of the Administration to move forward with legislation is a most positive sign. Unfortunately, the Administration's proposal, S. 615, contains many serious flaws that would in our view worsen, not alleviate, current market conditions. Therefore, INGAA cannot support the

Administration's legislative proposal as set forth in S. 615. INGAA has developed its own comprehensive program to address these problems and I will describe the five key initiatives of this proposal later.

BACKGROUND

Before proceeding to a discussion of the legislative proposals which INGAA recommends for consideration by the Congress, I would like to recite briefly the circumstances leading up to the current situation. There is no question that natural gas prices have risen sharply, more sharply than anyone expected when the NGPA was adopted in 1978. There is a very understandable urge to affix blame for these increases. Some are blaming the NGPA, others are blaming interstate pipelines, others are blaming producers, some blame state commissions or local distribution companies, some might even blame OPEC.

The truth is, there is no one person, no one segment of the business, no one decision that can be singled out as causing today's problems. Those problems have resulted from a complex set of legislative, judicial, regulatory, and industry decisions and conditions which are inextricably interrelated and much complicated by the state of our economy. This fact was recognized just last January by the staff of the House Subcommittee on Fossil and Synthetic Fuels in its thorough review of the current gas market problem. In its transmittal memo to the Committee on Energy and Commerce, the staff noted "it is probably inappropriate to point a finger of blame at any particular party or group of interests" for these problems.

In some quarters, pipelines have been accused of being insensitive to the price of gas. INGAA takes strong exception to this notion. Pipelines assume the responsibility to contract for sufficient reserves and to manage the flow of gas to their local distribution customers so that an adequate supply is available to meet customer needs twenty-four hours a day, seven days a week, three hundred and sixty-five days a year.

It must be understood that in order to fulfill this obligation, pipelines must plan years in advance. Natural gas is not a "shelf" item. A pipeline cannot wait until gas is actually needed before it goes out and buys it. On the contrary, a pipeline is expected to forecast what the demand for gas will be on its system as much as five or ten years in advance. This is particularly true if new facilities are required to attach a new source of supply.

Most of the natural gas flowing today is the result of decisions made in the 1970's and even in the 1960's. When pipelines were making these decisions, it was against a backdrop of chronic shortages and tremendous pressures from consumers for additional supplies of gas. When these decisions were made, no one could foresee the passage of legislation such as the Natural Gas Policy Act and the Fuel Use Act. No one could foresee the gyrations of oil prices. No one could foresee that our nation would be suffering through the deepest recession of modern times. Thus, the problems in today's natural gas markets were not reasonably anticipated when the pipelines were making their supply decisions. Moreover, these problems have resulted largely from factors outside the control of the gas industry.

The roots of today's market difficulties can be traced back to the Supreme Court's decision in 1954, that resulted in the imposition of wellhead price controls on natural gas purchased by interstate pipelines. Administration of these price controls proved totally unworkable and as a practical matter, the prices that interstate pipelines were allowed to pay were held far below market levels. While consumers enjoyed the benefits of cheap gas for years producers virtually stopped dedicating new reserves to the interstate market. Much of the new gas that was discovered was instead dedicated to the intrastate market where it was not subject to wellhead price controls.

The full impact of this seriously misguided policy manifested itself during the mid-1970's. Because the reserves of interstate pipelines had been drained to dangerously low levels, shortages began to appear and the service to many "low priority" customers such as industrial users, power plant users, and others was curtailed. As the record cold winter of 1976-77 swept over the nation, hundreds of factories were closed and thousands of workers were laid off because adequate supplies of gas were unavailable. Clearly, a change in Federal policy was needed and it was against this backdrop that the NGPA was considered.

The Natural Gas Policy Act of 1978 was the result of a bitter and divisive battle in the Congress over the direction of natural gas pricing policy. While it is easy to criticize the Act, it is also important to recognize that the NGPA was a substantial advance over previous policy.

THE CURRENT PROBLEM

The NGPA, in fact, has worked well to ease the critical supply shortages of the mid-1970's. Today, however, the country faces a different kind of problem: the problem of coping with excess natural gas deliverability and prices which are near or exceeding market clearing levels in many parts of the country. The marketing problems facing the industry today have resulted in large part from the rigidity of NGPA pricing provisions which adjust the price of gas upward, but not downward. In addition, the shortages of the 1970's and Federally imposed price controls forced pipelines to negotiate on contract terms rather than price. These contracts, signed in a seller's market, also tend to move gas prices inexorably upward by making the price controls in the NGPA price floors rather than price ceilings. They also threaten to trigger a fly up in gas prices on 1/1/85 if the indefinite pricing clauses present in such contracts are not diffused.

In my testimony of December 13, 1982 before this Committee I explained in some detail the current state of natural gas markets. I do not wish to repeat all of that discussion in this statement. Suffice it to say that there is a temporary surplus of natural gas and more gas is available for delivery than was anticipated a few years ago. At the same time demand for natural gas has fallen below the levels anticipated due to the economy, conservation efforts and falling oil prices, which, in the face of rising gas prices, have induced fuel switching from natural gas in the industrial sector. Couple this with a rigid body of producer-pipeline contracts that interact with existing law to move prices ever upward and require high levels of production, and the net effect is that retail natural gas prices are at or above market clearing levels in many parts of the country.

INGAA's RECOMMENDATIONS

Given these market conditions, a change is clearly needed. A legislative package that will bring needed flexibility to natural gas markets and afford protection for natural gas consumers is imperative. While there was not unanimity among INGAA's members on the legislation needed to resolve the industry's problems there is a clear consensus that the following principles represent the best means for addressing these critical issues.

In summary -

- o New-new gas would not be subject to the pricing provisions of NGPA.
- o A price cap would apply to all existing contracts (except 107) with indefinite price escalators.
- o A 50 percent limitation would be imposed on take-or-pay contracts.
- o An immediate market-out for high cost gas (Sec. 107) would be provided for both seller and purchaser.
- o A limitation would be placed on purchased gas adjustments.

I would now like to explain our proposal in greater detail.

1. New-new gas - Gas contracted for on or after the effective date of the legislation would not be subject to the pricing provisions of Title I of the NGPA.

In light of the distortions in today's gas markets there is little justification for extending the pricing provisions of the NGPA to new-new gas. Price controls such as those in the NGPA are a prime contributor to the inability of the industry to make timely adjustments to market conditions. Removing new-new gas from NGPA controls would enable such gas to respond to the demands of the market. We support decontrol of new-new gas at this time, because gas is in sufficient surplus that we believe prices for such gas could fall relative to the NGPA as a result of decontrol. While we do not have data on the full magnitude of the surplus, INGAA's recent survey of its members indicates that the surplus is substantial. We asked what volumes of gas pipelines could purchase under existing contracts but which they did not expect to take, given their current best estimate of domestic gas purchases. With fifteen members reporting (accounting for about 60 percent of domestic interstate gas supplies in 1985), we estimate a surplus deliverability presented in Table I:

TABLE I

Surplus Deliverability Estimates

Year	Surplus Deliverability for Pipelines Reporting
1982	0.7 Tcf
1983	2.1 Tcf
1984	1.3 Tcf
1985	0.5 Tcf

An estimated surplus deliverability in 1983 that exceeds 2 Tcf provides a strong indication that decontrol of new-new gas could lead to gas prices lower than those likely under the NGPA. Furthermore, the price paid for new-new gas would, under our proposal, provide the basis for a market sensitive cap on existing gas contracts containing indefinite price escalation clauses.

2. Price Cap to Defuse Indefinite Price Escalator Clauses (IPE) - All contracts in effect prior to the effective date of the legislation (except contracts for Section 107 gas), containing IPE or area rate clauses would be capped at the lower of the contract price or the "market reference price." The market reference price would be determined on the basis of the national weighted average price paid for new-new gas by all pipeline companies during the three most recent calendar months for which data are available. The capping mechanism would remain in effect until the contracts containing IPE clauses or area rate clauses are renegotiated or amended. In addition, the date of decontrol for the gas scheduled for decontrol on 1/1/85 would be moved forward to coincide with implementation of the cap. The cap would apply until the contract was renegotiated.

Given the contractual framework that exists today, NGPA ceiling prices are, in effect, floors. As the NGPA was designed to "ramp" prices for Section 102, 103, and 108 (and certain other) gas up to a market level, this should not be surprising. But in light of today's conditions Section 102 ceilings may already be at or even above a market-determined price.

This is evidenced by increasing reports of contracts being signed either below the ceiling or not calling for automatic escalations. The problem threatens to intensify in 1985, when the escalator clauses in contracts would trigger natural gas prices to still higher levels (the impact of these indefinite price escalator clauses has been discussed at length in earlier INGAA testimony).

Since much of the NGPA gas now scheduled for decontrol in 1985 is already at or near market clearing levels in many parts of the country, INGAA recommends that the date for decontrol be advanced from 1/1/85 to the effective date of the price cap. This would encourage renegotiation and coupled with the price cap mechanism, would assure that such gas would not exceed market levels. Furthermore, it would also prevent operation of the statutory increases established in the NGPA. Such action would go a long way towards meeting consumer concerns over the continuing rise in the cost of gas.

3. Take-or-pay - The maximum percentage for take-or-pay in existing contracts for gas-well-gas should be limited to 50 percent of deliverability for a period of three years from the effective date of the legislation. Take-or-pay payments will be made up from deliveries above 50 percent until fully recovered.

High take-or-pay levels in purchase gas contracts are an important contributor to the market anomalies we face today. It is difficult, however, to accurately estimate the magnitude of take-or-pay imbalances, for there is no publicly available data on the extent such clauses are affecting gas prices today. While not all companies are caught in take-or-pay situations, many of them are and it is a matter of serious concern for the industry. It is our best estimate, that a rollback to a 50 percent level is needed to achieve significant relief. The allowance for make-up of volumes not taken is a vital element of our proposal. Under the INGAA proposal, a pipeline would retain the flexibility to adjust the take rate to make-up volumes not needed in one period, at a later date. Additionally, we believe reductions in required takes will have a beneficial impact on price. INGAA is in the process of gathering industry-wide information about the potential effect if various maximum take-or-pay levels were legislated. Table II presents estimates of the maximum possible reduction in average gas acquisition costs (1983 and 1984) for the companies responding to date.

The estimated 1983 reductions (relative to projected 1983 gas costs without take-or-pay limits) range from roughly 11 cents/Mcf with a 75 percent maximum to 24 cents/Mcf with a limit of 50 percent on the minimum take level. The preliminary data for the 15 member companies responding to date on the take-or-pay inquiry indicate that acquisition gas costs could decline by as much as $840 million in 1983 with a 75 percent limit on the minimum take level ($930 million with a 70 percent maximum take[1]). The estimated maximum savings in 1983 increase to $1,470 million with a 50 percent limit.[2] These aggregate figures are for pipelines purchasing approximately 60 percent of domestic interstate gas supplies in 1981.[3]

1/ Linearly interpolated estimate using responses for 75 and 60 percent.

2/ These estimates of maximum savings assume that gas purchasers are free to choose the mix of gas supplies that they receive. This is not always the case. For instance, state pro-rationing regulations may not be consistent with this assumption.

3/ Based on EIA data, Natural Gas Monthly, January 1983, Table 15.

TABLE II

Projected Maximum Reductions In Gas Cost Through Take or Pay Limits

(1983 dollars)

Limit	1983	1984
75%	$0.11/Mcf	$0.22/Mcf
70%	0.13	0.25
60%	0.16	0.29
50%	0.24	0.33

We believe that these preliminary results strongly suggest that the benefits to gas users from a 50 percent limit on take-or-pay levels would be significantly above the benefit levels possible with the 70 percent level proposed in S. 615.

4. Section 107 Gas - Provision should be made to allow either party to a contract for Section 107 gas the discretion to terminate that contract within one year from the effective date of the legislation. If the contract is terminated, the purchaser shall be given an opportunity to exercise a right of first refusal of the best bona fide offer for the gas. If the right of the first refusal is not exercised, the first purchaser will transport the gas for the new purchaser under appropriate rates and conditions.

There can be no doubt that the opportunity to lower Section 107 gas prices would offer consumers in many parts of the country relief from rising prices. The NGPA was crafted to encourage development of this gas by decontrolling it in 1979 (except for Sec. 107(c)(5)). The incentive worked well. Unfortunately, as this gas began coming into a gas-starved interstate market, sellers were able to command extremely favorable contract terms. As the market for natural gas softened, many interstate pipelines exercised market-out provisions in Section 107 contracts. At least nine pipelines have exercised market outs between the Spring of 1982 and today. FERC Chairman Butler recently reported that estimates of the annual savings from market-outs approach three-quarters of a billion dollars.[4] It should be noted, however, that many contracts do not have market-outs or if they do, they are not exercisable until a future date certain, e.g., post January 1, 1985. In addition, pipelines have and will continue to seek renegotiation of contracts that do not contain effective market-outs, but these efforts have met with little success to date. It is important that market-outs be available relative to all Section 107 gas for while this gas accounts for only 6 percent of domestic interstate production in mid-1982, it represented 20 percent of interstate gas costs.[5] For these reasons, INGAA believes an immediate market-out for all Section 107 contracts is needed to facilitate the adjustments that changing market conditions warrant. This, we believe would provide a significant means for transmitting the marketing message from the burner-tip to the wellhead.

5. Limitation on the Passthrough of Purchased Gas Costs - For gas purchased under new-new contracts, the recovery of those costs via the PGA mechanism should be excluded to the extent that such costs exceed 110 percent of the national gas cap price. The NGPA "kicker" that automatically increases the ceiling price for Section 102 and Section 108 gas by 4 percent a month above inflation should be repealed immediately.

This proposal would restrain the upward pressure on prices reflected in PGA filings of interstate pipelines. As noted previously in my statement, the gas cap, using the national weighted average price of new-new gas, will reflect current market conditions and will act as a price

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4/ C. M. Butler, Chairman, FERC, letter to Honorable Philip R. Sharp, Chairman, House Subcommittee on Fossil and Synthetic Fuels, January 27, 1983, p. 3.

5/ EIA, "An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases," September 1982, Table 1; reporting on mid-1982 supply information.

leveler for gas purchases included in a pipeline's PGA. The INGAA proposal would require that for new contracts, any purchased gas cost significantly above average (i.e. above 110 percent) could not be recovered automatically, but would be subject to the provisions of the NGA. Hence, this proposal would protect consumers of gas while not placing impossible demands on the regulatory process.

INGAA believes that there must be a legislative initiative to solve the many problems now facing the consuming public and our industry.

To solve these problems we recommend most strongly adoption of our legislative proposals for decontrol of new-new gas; a price cap mechanism for indefinite price escalation contracts; a 50 percent limitation for "take-or-pay" contracts; an immediate market-out authority on Section 107 gas, and limitations on passthrough of purchased gas costs in the manner described.

This legislative package would, in our opinion, offer consumers immediate relief from the price and supply rigidities embedded in the current marketing structure without jeopardizing the stability of the industry during this transition period.

S. 615 - The Administration Bill

In several areas, S. 615 is similar to the INGAA position. For example, S. 615 would:

- Exclude new-new gas from the wellhead price control provisions of the NGPA
- Use a capping mechanism to defuse indefinite price escalator clauses
- Provide that pending renegotiation prices for all regulated gas would be the lower of the NGPA price ceiling or the gas cap
- Provide that the gas cap is the Federally approved rate for area rate clauses.

- Repeal demand constraints on natural gas (Title II of NGPA and certain Fuel Use Act provisions)
- Repeal NGPA Section 122

Although the INGAA and Administration proposals overlap in these areas the Administration's Bill contains major flaws which render S. 615 unacceptable to the interstate natural gas pipeline industry. The Bill in its present form would impede the transition to a market responsive to consumer demands, competitive fuels, and supply requirements. Furthermore, it would do great harm to interstate pipelines and put the interstate market at a great competitive disadvantage in relation to intrastate purchasers. I would like to address these matters in some detail, for it is important to distinguish between the descriptive labels being attached to these points and their true impact.

Restrictions on Recovery of Purchased Gas Costs (Sec. 101)

In the guise of "consumer protection" the Bill would not allow a pipeline to recover through its Purchased Gas Adjustment clause purchased gas costs in excess of those in effect prior to enactment, plus an inflation adjustment. To recover any costs exceeding this threshold level would require a FERC hearing and decision. The nature of the proceeding to be employed is not specified; only that it should not be an existing PGA proceeding and that it should not be a Natural Gas Act Section 4 proceeding. Although the FERC is directed to expedite this as yet undefined proceeding, it is given no guidance or statutory tools whatsoever; merely the prescription that the procedural rules it adopts "shall facilitate expeditious decisions."

INGAA strongly opposes this proposal. Apparently, its presence in the Bill stems from a popular, if uninformed, belief that (a) pipeline's don't care how much they pay for gas; (b) that the NGPA "guarantees" pipelines the right and power to force cost increases onto consumers, regardless of the impact; and (c) that consumer protection can be achieved by "squeezing" the pipelines' ability to recover purchased gas costs.

Unfortunately, the Administration has seized upon these misconceptions, making the so-called "pipeline accountability" test the "consumer protection" feature of its Bill.

First, let me address the allegations that pipelines are insensitive to purchased gas costs and the needs of consumers.

It is important to realize that interstate pipelines do not make money on the buying and selling of natural gas itself. They are allowed to earn a regulated rate of return on the transportation of natural gas. This rate of return is not guaranteed by FERC. If a pipeline transports less gas than it projected in its rate filings in a given year, it will earn less than the allowed rate of return. If a pipeline secures relatively low-cost gas for its customers, the pipeline does not benefit directly from its success. All of the benefits of the low-cost gas are flowed directly through to a pipeline's customers. Conversely, the burdens of higher gas costs are flowed through as well.

Pipelines are caught in the dilemma of satisfying both their customers and their suppliers. Pipelines have both a short and a long-run interest in keeping their purchase gas costs as low as possible. First, once a rate filing is in effect, a pipeline must transport the volume of gas projected in the rate filing in order to make its allowed rate of return and stay in business; second, by optimizing the use of its system the unit cost of gas to all users is lowered; and, third, a pipeline's viability is dependent on the markets it is authorized by FERC to serve and adequate supplies to render that service. If prices rise too high a pipeline's current and future market will decline and it will lose the opportunity to sell its transportation service. If the price of gas in the field is too low there is little incentive to explore for and develop new reserves to replace those used up. Moreover, both the physical structure of the pipeline industry and FERC regulation tend to tie pipelines to their existing markets. Thus a pipeline has strong incentives to purchase gas at reasonable prices not only to keep its product competitive with alternative fuels but to generate new supplies as well. Balancing these two critical elements of our business is a matter of great difficulty, particularly in these recessionary times.

There can be little doubt that the provision, as drafted, will adversely and dramatically affect most if not all interstate pipelines. Ironically, the pipelines with the lowest purchased gas costs would be affected most severely.

As I have noted, the intended purpose of Section 101 is to hold price increases on gas supplies to the level of prices being paid when the Bill is enacted plus inflation. This is accomplished by squeezing the pipelines through a provision which will not allow a pipeline to recover through its PGA mechanism any increase in its purchased gas costs above the level when the Bill passes plus inflation. The Administration has tried to equalize the inflation add-on to the pre-enactment PGA for each pipeline by calculating the inflation adjustment on the nationwide average PGA pre-enactment. This approach totally ignores the fact that, contractually, pipelines are obligated on large volumes of flowing gas to add 4 percent "kickers" to 102 and 108 gas volumes in accordance with the provisions of the NGPA. In other words, to the extent 102 and 108 volumes are purchased, the prices in later PGAs will be 4 percent higher than inflation. Additionally, because of the decline occurring in older, cheaper gas supplies, the pipelines constantly must replenish with newer, costlier supplies. This "mix" change has a decided upward impact on PGA costs since gas supplies costing $1 plus are taken out of the mix and replaced with gas supplies costing $3 plus.

The Administration would apparently argue that pipelines could offset this built-in upward pressure by renegotiating contracts and/or paying lower prices for NGPA gas, but neither of these options is realistic. Producers would have absolutely no incentive to negotiate lower prices prior to 1985 when, under S. 615, all parties would be granted a market-out option on that date.

While all interstate pipelines would be adversely affected by the PGA passthrough limitation, the basic unfairness of Section 101 is clearly shown by the deep disparity between the "allowed rate for purchased gas" for low cost pipelines compared to high cost pipelines.

As can be seen by Attachment A, the Administration's Bill would put the pipelines with the lowest average cost of purchased gas at a distinct disadvantage to the higher cost pipelines. Using the most recently available EIA data on PGA filings (September, 1982) INGAA calculated the maximum gas price cap level that pipelines (i.e., low, average and high cost) could afford to pay without having to go through the FERC approval process. Although the results in Table III shown are illustrative only and do not apply to a particular pipeline they very graphically show the bias against the companies with the lowest cost gas:

TABLE III

Company-Specific Limits Adjusted by a "National Average" Inflation Increment (mid-82 dollars per Mcf)

Year	Low Cost Pipeline	Average Cost Pipeline	High Cost Pipeline
1983	2.56	3.05	3.16
1984	2.38	2.96	3.14
1985	2.24	2.88	3.10

The Administration's method, thus, penalizes low cost pipelines significantly and generates a rather wide range in the relative gas supply bargaining opportunities among pipelines. The end result will inevitably be that the pipelines which have achieved the lowest cost will have little opportunity to buy new gas supplies in competition with other interstate pipelines as well as intrastate purchasers who will be in a position to offer higher prices for gas without the cloud of regulatory approval hovering over them.

But even apart from this obvious discriminatory result, average and high cost pipelines would also be severely inhibited in acquiring new reserves. The spectre of FERC approval or disapproval of prices above inflation, with the attendant regulatory delays, is a disincentive not only for pipeline purchasers but for producer-sellers as well, to bring gas into the interstate market. This is especially true since intrastate purchasers would not be subject to the same limitation and would be in a position to out-bid interstate pipelines. This would re-create the dual market for gas which the NGPA sought and in fact, effectively eliminated. INGAA cannot conceive that a return to the dual market is in the public interest.

It is argued that pipelines should not be concerned about this provision, for it clearly states that properly incurred costs should be allowed. This is scant comfort for interstate pipelines seeking to buy gas in competition with other purchasers when, to acquire particular gas reserves, it is necessary to exceed its allowed purchased gas cost. Needless to say, the interstate pipeline industry is highly skeptical that the FERC would be able successfully to process the necessary filings in a timely manner. Historically, the regulatory process is characterized by interminable delay, despite the best efforts of the Commission. I would note that over four years have passed since passage of the NGPA and the FERC has yet to reach a final decision on the treatment of production related costs. How many years would pass before the meaning of this new PGA test would be determined?

As a practical matter, the inclusion of the Administration's PGA restriction in a natural gas bill would force interstate pipelines to either curtail new gas purchases or insist on "FERC-out" clauses in contracts. Would producers be willing to sell gas to interstate pipelines knowing that in a few months, or even years, an adverse ruling could void the contract? If this occurs, the "consumer protection" clause would surely cause a return to gas shortages in the interstate market.

Two other aspects of the PGA passthrough limitation raise serious problems for the industry. First, as presently structured, it would include pipeline PGA's covering pipeline to pipeline purchases. While the Bill, as we understand it, is intended to address wellhead purchases it sweeps in the costs incurred by pipelines for moving gas to another pipeline purchaser, all of which are passed on to the buying pipeline. Clearly, pipeline to pipeline PGA's should be excluded from the passthrough limitations of S. 615. Under the cost plus inflation limitation of Section 101 successive pipeline purchasers would be required to go through the FERC approval process on every PGA from their supplying pipeline. Since the pipeline purchasing gas at the wellhead will already have had its purchased gas costs approved, there is no reason or justification for a second pipeline to have to go through the process again and again.

Secondly, the Bill would place stringent, irrational, and unworkable restrictions on the purchase by pipelines of gas from affiliates (or the pipeline itself). The provision states that a pipeline cannot recover any costs of such gas to the extent the rate of take from such production exceeds the rate of take of any less expensive gas.

This requirement is hopelessly unfair and unworkable. A pipeline is forced to vary its rate of takes from the hundreds of wells feeding into the pipeline for a multitude of reasons. Geological reasons, such as drainage requirements, may make a low take rate undesirable or even impossible. The physical capacity of a pipeline system may preclude high take rates in some locations. In older fields, lower take rates may be a necessity. On the OCS, high rates of take have been encouraged and are sometimes required. In addition, would the standard be applied on a daily, monthly, or annual basis? How would multiple ownership properties be handled? What if high takes are necessary to work off take-or-pay prepayments?

These and a multitude of other factors influence the rate of take from any given well. While the requirement may have superficial appeal, there is no practical way to implement it, short of banning pipeline owned production and affiliate production altogether. Furthermore, it is blatantly discriminatory against pipeline companies with such production. It would also run squarely against the encouragement extended by the government to pipelines during the 1970's shortfall to establish production affiliates as a self-help measure.

The NGPA already contains perfectly adequate safeguards governing the purchases of affiliate production (Sec. 601(b)(1)(E)).

Finally, it should be noted that pipeline companies have developed such programs at no small risk and with heavy investments of capital. This proposal, would cause great hardship for many pipeline companies, and would discourage them from pursuing any meaningful search for new reserves of gas. We fail to see how this is in the public interest.

In summary, the Administration's "pipeline accountability" standard would not help consumers, but it could easily hurt consumers and severely cripple the interstate pipeline industry. The standard proposed is an arbitrary one that has no relevance to market conditions. Consumer protection requires that wellhead natural gas prices be responsive to retail market conditions. The PGA restriction in S. 615 would hinder, not facilitate this objective.

Decontrol of "Forever Regulated" Gas

S. 615 would effectively decontrol "forever regulated" gas by 1985 by allowing such gas to be freed from price controls if renegotiated prior to 1/1/85 and by allowing producers to "market-out" such gas after 1/1/85.

INGAA is opposed to this proposal to decontrol "forever regulated" gas. Decontrol of old gas as proposed could cause substantial price increases on pipeline systems with large quantities of old gas. While it may be true that average prices might not be significantly higher at the national level, the rate of increase in prices for consumers on some systems could be large. Because the PGA passthrough mechanism limits automatic passthrough of price increases to inflation through 1986, decontrol of old gas for low cost pipelines could create an administrative nightmare at the FERC.

It is INGAA's view that the decontrol of old Section 104 gas coupled with the extensive market-outs proposed in the Bill could seriously impact the entire structure of the industry. While decontrol of old gas may eventually be desirable, the abrupt termination of controls in 1985 could produce seriously adverse results.

Take-or-Pay Limitation

The proposed 70 percent take-or-pay limitation in S. 615 (Sec. 302) is a move in the right direction, but its beneficial impact would be minimal, unless two changes are made: the allowed reduction in take levels should be 50 percent and provision should be made to insure that pipelines can make up volumes already paid for but not yet taken from deliveries above 50 percent until fully recovered.

As I noted, there is little solid, publicly available data relating to the impact of one take-or-pay level on prices relative to another. Based on the data available to INGAA, however, our best estimate is that a reduction to 50 percent would be necessary to achieve meaningful relief without unfairly burdening producers. Moreover, as I have previously pointed out (supra, p.9) the benefits to gas users from a 50 percent limit on take-or-pay would be significantly above the benefit levels possible with 70 percent.

I wish to stress here the importance of specifically providing for the right of make-up of volumes not taken. Given the prolonged recession and the growing backlog of volumes paid for but not yet taken, the provision acquires an even greater urgency. We strongly urge INGAA's approach to this problem.

Furthermore, the right of the producer to sell to another producer that portion of the gas reduced to the take-or-pay level would hinder the pipeline's flexibility in adjusting its gas purchases to market conditions.

Access to Gas Supplies by Other Buyers

Title IV of S. 615, operating in conjunction with certain other provisions of the Bill, is the so-called "equal access" Title. This is a misnomer. The allegation has been widely made that intrastate pipelines are somehow denied access to certain gas supplies; that "interstate" gas is not available to intrastate pipelines and that these barriers should be broken down. In fact, few if any such barriers really exist. Intrastate interests contend that they should be granted access to Outer Continental Shelf gas supplies. In the matter of on-shore supplies, they argue that intrastate pipelines should be permitted to purchase gas for what is essentially a sale in interstate commerce for resale and have that gas transported across state lines by an interstate pipeline without the transaction being considered jurisdictional. In essence, intrastates seek nothing less than the opportunity to act as an interstate pipeline without being subject to the regulatory responsibilities of being an interstate pipeline. INGAA submits that to permit such activity on a non-jurisdictional basis would confer upon intrastate pipelines not equal, but preferential access to natural gas supplies.

The Congress should not be lulled into believing that the provisions in S. 615 are harmless. If approved in their present form, these provisions together with the freedom from PGA limitations and the wholesale marketing out of gas as provided for would re-establish the dual market for gas that existed prior to passage of the NGPA. Intrastate pipelines would have far more flexibility to bid for gas supplies than would interstates, who must seek FERC approval of proposed rates, facilities, and other operating requirements.

As INGAA has stated many times in the past, it does not object to an expanded role for intrastate pipelines, but only on terms truly equal. If an intrastate wishes to buy and transport gas on the OCS or in a "foreign" state, it should be allowed to do so, but only through an affiliated corporate entity that would be a "Natural Gas Company" within the meaning of the Natural Gas Act and the Natural Gas Policy Act. Few, if any legislative changes would be required for intrastate pipelines to operate in this manner. INGAA would be willing, I might add, to support a legislative assurance that such operations would not cause the parent company to become a jurisdictional company. If intrastate pipelines truly seek "equal", not preferential, access they should not object to such a proposal.

Contract Carrier Requirement

Several portions of the Administration's Bill, most notably Section 403, touch on the issue of contract carrier status for pipelines: the conditions under which such transportation should occur and the financial compensation a pipeline would receive for such transportation. Contract carriage is not new to our industry. Many of our members presently transport gas owned by others but because of the service obligations to existing customers and the lack of monetary incentives it is not a major part of the interstate pipeline system. Moreover, under the Natural Gas Act pipelines cannot be ordered to expand their facilities to add more capacity, and there is little incentive for the pipelines to do so under the present scheme of regulation.

INGAA is not adverse to the possibility of expanded contract carrier arrangements. Indeed, the frequency of such arrangements has increased dramatically over the years and a review of the policy surrounding contract transportation could be healthy. However, we are obliged to point out that complications exist which must be addressed within the context of the proposals embodied in Section 403. Pipeline companies must fulfill their service obligations. Pipeline capacity, which is generally approved pursuant to the fulfillment of those responsibilities, must be available for that purpose and cannot be committed unconditionally to other purposes. Another complicating factor is how distribution companies would be affected if purchases are made by end users on their systems.

These issues, which tend to become more complex the broader the contract carrier scheme, must be given careful attention. Unfortunately, the language of Sec. 403 is too vague and indefinite and fails to take into consideration the many critical issues that would face the industry if this major change were to be adopted.

Summary of S. 615 Review

S. 615 has some positive points, but it would require major surgery to overcome the numerous flaws that render it unacceptable. I have attempted here to address some of INGAA's primary concerns but other provisions such as the treatment of Section 107 gas and the extensive use of market-outs, warrant the closest scrutiny by the Congress, as well. In sum, the Bill, in INGAA's view, would worsen, not alleviate, current market conditions. In its present form it would impede the orderly transition to a market responsive to consumer demands, competition and supply requirements. Moreover, it would do great harm to interstate pipelines and put them at a competitive disadvantage in relation to intrastate purchasers.

Other Bills

INGAA is aware of the other legislative proposals pending before the Committee. Most of these Bills are narrow in scope and similar to Bills introduced last year, (S. 60, S. 239, S. 291, S. 293, and S. 370). As I stated at the outset of my statement, INGAA believes that a comprehensive solution such as I have outlined is necessary. For this reason, INGAA cannot support these other proposals.

S. 689, recently introduced by Senator Heinz is a substantial proposal which appears to contain many interesting but also some adverse elements. INGAA has not been able to thoroughly review the impact of the Bill, and I am not in a position to comment on it today.

Conclusion

As I stated at the outset of my statement, INGAA believes that a comprehensive solution to the many problems facing the gas industry is imperative. S. 615 has brought the issue to the forefront, and the Administration is to be complimented for seeking its introduction. Regrettably, it does not address adequately the complex issues which surround the whole question of natural gas regulation.

INGAA's recommendations for natural gas legislation, we believe, will bring needed flexibility to natural gas markets and afford protection for natural gas consumers against unwarranted escalations in gas prices. These are issues of vital importance to all gas consumers, the public and the industry. We strongly urge the Congress to move rapidly in developing a meaningful legislative program along the lines I have recommended.

I appreciate the opportunity given INGAA to present its views to the Committee and would be pleased to answer questions.

ATTACHMENT A

ESTIMATES OF MAXIMUM PRICE PAYABLE FOR NEW AND NEW NEW GAS (Mid-1982 dollars per Mcf)

S.615

Rule:	Company-specific limits adjusted by a "national average" inflation increment
Outcome:	Penalizes low cost pipelines significantly and generates a rather wide range in the relative gas supply bargaining opportunities among pipelines.

These calculations generate an estimate of the maximum "gas price cap" level that the particular pipeline could afford to encounter without requiring FERC approval.

Year	Low Cost Pipeline	Average Cost Pipeline	High Cost Pipeline
1983	2.56	3.05	3.16
1984	2.38	2.96	3.14
1985*	2.24	2.88	3.10

METHODOLOGY

Using the latest available (mid-1982) supply information from the EIA** we generated the following supply situations to illustrate low, average, and high cost pipeline situations (for wellhead purchase only, no pipeline-to-pipeline purchases).

	Low Cost Pipeline		Average Cost Pipeline		High Cost Pipeline	
	Volume	Price	Volume	Price	Volume	Price
Old Gas	400 Bcf	$0.90/Mcf	290 Bcf	$1.30/Mcf	360 Bcf	$1.60/Mcf
New Gas	90	3.00	190	3.20	420	3.20
High Cost Gas	0	- -	30	7.50	90	7.60
TOTAL	490	1.29***	510	2.37***	870	2.99***

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* Mid-1985 figures (after the 1/1/85 market outs) are provided for information concerning 1/1/85 status.

** EIA, "An Analysis of Post-NGPA Interstate Pipeline Wellhead Purchases," September, 1982.

*** This figure is the weighted-average price paid by each pipeline.

The calculations make the following assumptions:

- 10% decline rate on contracted-for gas supplies
- 5% annual inflation
- each pipeline must purchase a constant volume of gas in each year.

Senator **Heinz**. Mr. Lawrence, I regret I missed you and Mr. Zeigler and about half of Mr. Moring's testimony; I was over on the floor.

So, if I ask you a question you have already answered, please forgive me.

To what extent—and I may just ask you for a very brief response each—do you feel that the President's proposal, to decontrol the old gas—will result either in higher average prices or in less production of new gas?

Mr. Lawrence.

Mr. **Lawrence**. We think it will do both. I think by the administration's own analysis, it will do both. The simple numbers are, over the next 3 years, that if you decontrol old gas, there is going to be about a $20 billion transfer from somebody to the old gas producers.

The administration says the new gas producers will negotiate the contracts downward, and make that up; if they do, new supply incentives will suffer dramatically.

If they don't, consumers will suffer. If you impose the rigid PGA ceilings, the interstate pipeline companies will suffer, and out of that $20 billion their total net profit couldn't exceed a billion.

Senator **Heinz**. And as to additional supplies?

Mr. **Lawrence**. I think it would be harmful to new supplies.

Senator **Heinz**. Mr. Zeigler, do you share that point of view?

Mr. **Zeigler**. Yes; I share it, and I will mention this, that even though our particular pipeline, Transco, might benefit more so than other pipelines because they only have 24 percent old gas, nationally, I think it would be the wrong thing to do.

Senator **Heinz**. Mr. Moring.

Mr. **Moring**. I think Mr. Lawrence and Mr. Zeigler have said it well, and so I would simply echo what they have said and add the proposition that I think everyone who has studied the question is agreed that the Nation is not now blessed with long term, proved gas reserves in anywhere near an adequate quantity, than at, we would be running a great risk were we to adopt it as a national part of our energy policy.

Anything that discouraged exploration and development for new natural gas reserves—I think the rewards for that kind of effort ought to probably be increased from what they are today.

Senator **Heinz**. Mr. Cooper.

Mr. **Cooper**. Both, Senator Heinz. It will increase——

Senator **Heinz**. You think there would both be an increase in average price——

Mr. **Cooper**. Both be an increase in average price, short term, and an even larger increase in price in January 1, 1986——

Senator **Heinz**. And no——

Mr. **Cooper**. No benefits from the standpoint of exploration and development of new gas.

Senator **Heinz**. Mr. Rodemann.

Mr. **Rodemann**. Senator, there is a real world outside that goes beyond speculation. The basic thought that has made this country great is competition, and you cannot artificially keep the cost of a product down below its market value. That is the reason why we have this so-called gas shortage because regulation kept natural gas low to begin with, and keeping the gas low created the shortage.

There are the reserves in the Nation that have to be explored and developed and produced. I can't predict the short-term impact on this. Obviously, just the introduction of this legistation may freeze a lot of action in the market and the producers in the interstate pipeline companies' interest. They may wonder what is going to happen.

So, the most dangerous period I can see right now is from now on until a bill is passed. After that, once the market is freer to breathe and act, business will take over.

Senator HEINZ. I will put you down with respect to my two questions as a question mark.

My question was, will prices, on average, go up—and will there be any significant increase in production or not?

Mr. RODEMANN. I think nobody can predict it. Now, you will get feelings. I don't think anybody can predict it.

Senator HEINZ. I put you down correctly. I put you down with a question mark.

Mr. McGrath.

Mr. McGRATH. Senator, I think the answer to your question it will be uneven so far as interstate pipelines are concerned. We have a number of pipelines that have large amounts of old gas and decontrolling that would have the substantial price impact on those companies.

I would guess the result could well be that the average price of gas could go up for them. On the other hand, we have a good number of pipeline companies who have very little or low quantities of old gas, and I don't think that that would affect the price significantly at all, so you can't make it as a general proposition.

Senator HEINZ. In some cases there would be significant run-ups and in others, no change?

Mr. McGRATH. Not no change but very little change, I would think, but yes.

Senator HEINZ. And, as to supply?

Mr. McGRATH. As to supply? We don't have any good hard figures on that, but I don't think that it would significantly stimulate supply.

Senator HEINZ. Now, one of the issues you may all have addressed in your full remarks because everybody worked very hard to summarize, and did a super job within the time limitation—would that we were as brief.

Is the issue of pipeline accountability over the longer term, in the administration's bill there are no genuine requirements, as I would view it beyond January 1, 1986.

Do any of you favor a long-term pipeline accountability standard? If so, what kind of standard?

Let me start around this side—Mr. McGrath.

Mr. McGRATH. Well, let me preface my answer by saying that, by and large, we think the pipeline companies have been doing a good job in supplying, and these are their customers. We have been in the switchers here. As you know, the focus has been on the interstate pipelines as being the bad guys in this act, and we don't think we are. We have made some bad deals, certainly, in the past.

But we are caught in a dilemma in having adequate supplies for our customers, and having to pay the price for that gas, and at the same time, at the other end of the line, the distributors who are faced with real marketing problems, and I think it has to be understood that, as I point out in my full statement, that the interstate pipelines just don't go out and buy gas one day to sell it the next. It is not a shelf item, and the contracts that we have are longstanding, long-term contracts. They have built-in rigidity, and you couple that with the recession we are in, with the rigidities of the NGPA, and we have had some very rigid prices that cause a disruption in the market.

Now, having said that, if it is the will of Congress, and if our customers or distributors insist that there be accountability, we have proposed in our legislative proposal which I described very briefly, a provision for limitation in the PGA passthrough wherein the 4 percent adjustment now in the act would be eliminated, to begin with, and we would use the national weighted average cost of new gas purchases, which we believe will reflect what the market will take these days, in competition with oil, and you heard testimony earlier today about what is happening in Kansas City and in other areas, on that score.

We believe that the national weighted average will reflect lower prices than what pertain now under the NGPA, and a pipeline company could not automatically passthrough any costs exceeding 110 percent of that national weighted average price, and if it does do that, it would have to go to the FERC, as in the administration's bill, although the procedures that are set forth there, we take serious exception to—would have to go to the FERC for approval; and that would continue on beyond 1986—I guess, until such time as the market begins to sort itself out.

Senator HEINZ. How would you feel about a prudent standard?

Mr. MCGRATH. Well, under this proposal, going to the commission with any costs that exceed that limitation, you would be under the just and reasonable standard of the Natural Gas Act, and I think the commission has, in some cases, and in many cases, viewed that as including in that J&R standard a test of prudence.

Senator HEINZ. I would agree.

Mr. Rodemann, how do you feel about extension of pipeline accountability standard, the application of just and reasonable prudence?

Mr. RODEMANN. Senator, I think the prudence issue came up because it has been alleged that companies bought high-cost gas. Some of those purchases may have happened during periods of severe curtailment, and I cannot fault a pipeline company for having reacted at that time in the best interests or what I thought was the best interest of the customers.

I recognize that, even though we pay for the gas, but if there is an excessive abuse in the marketplace, then that should be stopped.

But the definition of the word, "prudence," leaves me somewhat cold. It has to be somewhat more specific.

I simply say, you cannot play Monday morning quarterback for things that happened in the period of crisis.

Senator HEINZ. Do you think the present fraud and abuse, so-called standard, very successful?

Mr. RODEMANN. I think the most recent proposals to more clearly define what is meant by it, they go in the right direction. The only problem with that is sometimes there is a good intention in their rule or regulation, and, then, it is being abused by administration staff, FERC staff, or so on, and it goes to the other extreme.

This also holds true for the consideration of the whole deregulation concept.

Congress must be careful not to go overboard into the other direction. So, there has to be a measure and a moderate action and reaction to everything we do.

Senator HEINZ. Mr. Cooper.

Mr. COOPER. Senator Heinz, we are very anxious to see any legislation deal with this issue, and we are very happy to see your bill get into the subject.

When the NGPA was enacted, the distribution company in the market were the forgotten people, and something has to be done that is constructive.

We might say that over the years all of the leverage of the market has been pretty much against the field prices, has been pretty much destroyed by the way in which pipeline regulation has proceeded, and by the forms of tariff that the pipelines used.

We would like to see legislation get into accountability by changing and improving the pipeline tariffs in a way that will bring market forces to bear on field prices; and we are happy to see that your bill has provisions in running to that effect.

Now, on the question of section 601, and your question about prudence, I think the problem from our point of view, is how far you carry that.

We don't like to see anything done by way of pipeline accountability which is going to, in any way, let FERC decide what field prices should be. We don't think that the FERC should be deciding run-of-mine cases, and saying "This price is prudent" and "That price is imprudent."

Because then you are going to get back into the same problem of, indirectly, of having FERC set prices; and if you get into a period of shortage again—we are heading for it—you are going to have a two-tier market again, the same problem that we had before NGPA.

On the other hand, if you are talking about pipeline practices, that is, how they are handling their supply operations, and things of that sort, prudence should govern.

Now, I think if you are going to approach the thing through section 601(a), you should do it through a definition of the term "abuse," or an add-on to that language, "fraud, abuse, and other," and say exactly what you want FERC to do.

Senator HEINZ. So, you don't——

Mr. COOPER. And we have been trying to work on definition of languages of that kind, and will be happy to see it considered.

Senator HEINZ. But you think it would be—you have reservations about the idea, of applying your sections 4 and 5 of the Natural Gas Act.

Mr. COOPER. Only because we are afraid if we do that, that you are opening up the way for people to litigate and get FERC back into the field price-fixing process again; and we are very anxious that that shall not occur.

We are very anxious on the other hand to see FERC hold the companies' feet to the fire on what are sound operating practices.

Senator HEINZ. Mr. Moring, you would favor, as I understand it, the kind of pipeline accountability standard that I have in my bill.

How would you respond to Mr. Cooper?

Mr. MORING. Well, I would respond this way—that the fear that Mr. Cooper expresses, that if sections 4 and 5 were made explicitly by some new statute applicable to pipeline reregulation, which they already are, in my opinion anyway; but if that were restated in a new law in a new way, in that event, FERC would regard that somehow as authority to exercise some sort of backdoor, wellhead price control jurisdiction.

Now, if I were seriously concerned about that problem, which I am not, then I would probably satisfy Mr. Cooper by including sort of a negative covenant in such a bill which said that "Nothing herein or in any other law shall confer on FERC jurisdiction to prescribe wellhead prices for decontrolled natural gas."

I would see that as something I could recommend to the Senator and to my client, and hopefully Mr. Cooper and I go arm and arm in favor of pipeline accountability at that point.

Senator HEINZ. One moment.

Mr. Chairman, I have no idea whether I am 7,000 hours past my time or not. I haven't heard any egg-timer go off, but I——

The CHAIRMAN. You are a 300-pound gorilla; you just sit wherever you want and ask the questions.

Senator HEINZ. I have been called worse things. [Laughter.]

Not lately.

Mr. Zeigler.

Mr. ZEIGLER. Senator Heinz, I would like to react to this as a distributor because I think we have to work very closely with our State commissions, and with the NARUC group—the National Association of Regulatory Utility Commissions.

They look to us to be prudent in our actions with our pipelines. We have to look to the laws of the land to set that accountability. We have these PGAs come forward.

For example, the cost of gas today represents 75 cents out of $1 of the retail selling price of the gas. Taxes are 10 percent. Our payroll, about 5 percent. The other 10 percent is really what the utility commission has control over. They guard that 10 percent very carefully. They want to be sure that we go to bat over the 75 cents, that we pay out in our bills to our pipelines.

So, I think we have a real chain, here, of two regulated segments of this industry. There has to be some type of accountability that goes beyond just ruling on the rate of return on investment of pipelines.

Senator HEINZ. What mechanism do you think? We have got different ideas so far.

Mr. ZEIGLER. Well, I think we have in place certain sections of the Natural Gas Act, that work may be good and bad throughout the 40-year period; but certainly accountability has to be one part of a regulated industry. I don't think you can have a regulated segment, and not have accountability.

Now prudence has to be a part of that.

Senator HEINZ. One last question for Mr. Moring.

Mr. Moring, in your opening statement you had some rather startling things to say about some of the FERC decisions, if I understood you correctly, that you believed if it were improper and if it reversed, it would result in some $25 billion in lower rates to consumers in the next 12 months; is that correct?

Mr. MORING. Yes, sir; $25 billion at a minimum.

Senator HEINZ. Could you elaborate on that?

Mr. MORING. Yes, sir. Let me modify your question just a little bit and say that rather than modify or reverse any FERC decisions or other final decisions, the Heinz bill and the provisions to which I pointed in my opening statement would simply resolve what is currently outstanding in the nature of a dispute. Let me be specific.

In early 1979, there was created a system of protests for what we call area rate clause litigation, which, when you put that in the context of what I have characterized as sweetheart deals between the pipelines and the producers, we think it is probably worth in the neighborhood of $10 billion.

Now, that is a very large number, even by Washington standards.

Senator HEINZ. Let me interrupt to see if I understand the situation.

These area rate clauses apply mainly to old gas, or some new gas as well?

Mr. MORING. Well, I am speaking primarily in terms of old gas; yes, sir. But some new gas is included.

Senator HEINZ. As I understand what you are saying is that the FERC, notwithstanding the plain language in the contract, this was all gas that was under contract?

Mr. MORING. Yes, sir.

Senator HEINZ. In from these areas subject to a ceiling price, that doesn't make any difference whether your contract does not provide for an escalation here, we are going to allow you to charge a higher price equivalent to the ceiling price; is that the sum and substance of what you are saying?

Mr. MORING. Yes. The qualification that I would make on your statement is that they said on an interim or administrative basis subject to refund, we will permit collections to be made at the ceiling price if you have something that we are now describing as an area rate clause without regard to the particular language that is found in that clause.

Senator HEINZ. But it was a tentative decision, as you say, subject to——

Mr. MORING. Yes, sir. And those refunds have been accumulating since December 1, 1978, and are now piling up in very, very large amounts. And I might say, the thing that FERC most overlooked and that I think most observers have overlooked over the years since NGPA was enacted is the fact that the pipelines, by other provisions of the same contracts, had conveyed away to the producer their ability to resist the producers' assertion that the ceiling price was, in fact, the price the pipeline should pay for the gas in question.

So, in order for the pipeline to resist the payment at the ceiling price, the pipeline found itself in a position of having to breach the contract.

Now, that is a mouthful, and that is what I mean by a sweetheart arrangement. It is the fact that those sweetheart arrangements, taken together with area rate clauses, place the pipelines in a position where of course they had to pay the money at the ceiling price because the producer asserted its entitlement to it, and the pipeline had no ability by and large in a common place arrangement to resist that assertion.

Mr. McGrath. Senator, I'd like to respond to that, if I may.

I don't hold any brief particularly for the producers, but I do for the pipelines. The description that Mr. Moring has used, I think, is very careless and uncalled for. I think you have to——

Senator Heinz. Which description?

Mr. McGrath. Well, the sweetheart contracts between the pipelines and the producers.

Senator Heinz. All right.

Mr. McGrath. I personally have no basis to judge the accuracy of his $25 billion figure. I haven't been that much involved in the proceedings so I don't want to question that one way or the other, but I am going to tell you this. That because of the regulatory scheme under which we operated and do operate today, and the producers were operating before the NGPA and what Mr. Moring is talking about are mostly your older contracts that precede NGPA. These go back many, many years. That a producer who is committing his natural gas to the interstate market to serve Mr. Moring's clients, looking down the road, committing their reserves for 20 years or longer because under the Natural Gas Act they cannot, once they get into interstate commerce, cannot abandon that service without specific approval to the Commission. So, you have reserves committed for years and years and years.

And as businessmen, they look down the road and say, "Well, if there is a change in the federally approved rate, I am going to put a clause in my contract that says that if that takes place, I am at least going to have the benefit of that higher rate when I commit my product to you, the pipeline and the pipeline to you, the distributor, for those many years."

And when the NGPA came along and established a new pricing regimen, and this is for old gas as well as new gas, the producers went to the Commission and argued that this ought to be considered a federally approved rate.

I am not going to hold a brief for them. It is in court now. I mean, it has been battled back and forth and I don't want to get into the legal ramifications, but they were not sweetheart deals between the pipelines and the producers. They were deals that were made on the table between two bargaining parties signing up long-term contracts.

Senator Heinz. Irrespective of the terminology, and I don't want to choose sides on terminology, if I understood Mr. Moring correctly, what he is objecting to in particular are increases where there was not the kind of authority that you cited. That if there was a higher Federal price established, that there would be a right to it, to receive it.

Now, maybe I am misinterpreting Mr. Moring. I don't know.

Mr. **Moring**. Well, let me elaborate just a little bit.

The question for lawyers in this context, and I hope I can state it in English, is whether, in fact, the seller, the producer, did, indeed, have contract authority when he had an area rate clause to collect the NGPA ceiling price.

Now, FERC set up a procedure whereby parties such as gas distributors, that I represent, could assert that a given set of language, or pricing provisions known to be in the family of area rate clauses, whether such provisions did, indeed, confer on the seller the right to collect the ceiling price based on the plain meaning of that language.

Now, the procedure that FERC created said this. That if the pipeline and the producer agree that a given pricing provision does allow the seller the ceiling price, then that will be the price that on an administrative basis will be paid, subject to refund, if we ever get around to resolving what the contract really means.

That has been pending. They have never gotten around to that resolution since 1979. We filed our evidence almost a year ago seeking a hearing.

What I am also saying is that of course the pipelines and the producers agree that the seller was entitled to the ceiling price because once the seller asserts his entitlement to that and having conveyed away his ability to resist that, the pipeline will agree.

So, if you read the contracts carefully enough, you will see that the Commission was laboring under some kind of misconception that that would have been a fair, arm's length kind of resolution between the parties when, in fact, it had already been settled by the contracts. They just didn't look at the entire contract.

Mr. **Lawrence**. Before Senator Heinz gives up the floor, if I could just refer to another sweetheart deal——

The **Chairman** [presiding]. Certainly.

Mr. **Lawrence**. I, on behalf of the American Gas Association, we just want to express our appreciation to you for the timely action you took in the last Congress to pass legislation to be sure that low income and social security recipients wouldn't have their pay deducted as a result of receiving low income fuel assistance.

I think that is very important and I think a lot of people are benefiting from it during this very winter. I appreciate it. It is very useful.

The **Chairman**. Mr. Cooper, you indicated that you would like to add something.

Mr. **Cooper**. I don't want to extend this debate, but it seems to me that these old contracts had area rate clauses in them and this matter is in court being thrashed out. I would think that this major problem of dealing with the present price situation and getting prices down shouldn't be approached through Congress sort of trying to settle all of that litigation because it is an extremely complex and difficult thing, and I am sure that there are equities on both sides of it.

We would much prefer to see you deal with getting prices down, but by doing it across the board on ceiling prices and not trying to settle this past litigation.

Mr. MORING. May I say that area rate clause litigation is and has been pending in FERC since we filed our protests in mid-1979. It is not tied up in court. It is pending right there where it has been for almost 4 years.

Senator HEINZ. That's a long time.

The CHAIRMAN. As lawsuits go, that's not long.

Mr. MORING. Sir?

The CHAIRMAN. As lawsuits go, that's not long.

Mr. MORING. Not for $10 billion it's not.

The CHAIRMAN. We can probably create enough confusion in any legislation we pass to keep you and your son and your grandson busy. [Laughter.]

Senator HEINZ. Mr. Chairman, do you say that as ranking member of the committee or——

The CHAIRMAN. No; I say that as a former practicing lawyer, looking at what Congress has done in the past. Like a bull in a china shop. I have the greatest conflict of interest of anyone. I have one son who is a lawyer and one who is an accountant and we make enough work every day to keep them both busy.

Mr. MORING. I would simply want to put this perspective on it, Senator McClure. That we have here a situation that by the stroke of a pen, FERC could, if it were to act pursuant to its statutory authority, roll back prices on the one case by $10 billion.

We have another case where there is another $10 billion, and that is called the section 110 regulations that they issued on January 24 of this year. That is $20 billion. And we have yet another case known as the "liquids and liquifiables" case which is worth another couple or $3 billion, we think maybe if somebody would give us the data that we have sought.

Finally, there is one more litigation known as the "Btu adjustment" litigation which, again, FERC could give us a hand. So, FERC could do us a $25 billion roll back and you wouldn't have to pass the law which you fear would employ my grandson.

The CHAIRMAN. Well, I suspect that if FERC did everything that you wanted it to do, someone else would complain.

Mr. MORING. Well, I assume they would for that kind of money.

The CHAIRMAN. I assume so, so there is still hope for your grandson. [Laughter.]

One question, Mr. Zeigler. You have indicated in your statement at page 10 that if this were resolved, and I want to use the exact language you did—"As we understand the operation of Senator Heinz's proposal, rate reductions approximating some $25 billion would become available during the first year after its enactment."

Are you referring to just the amounts—the differential in the costs during that year, or are you referring to the amount of money that has been accumulating, subject to the refund provision?

Mr. ZEIGLER. Paul, you had better answer.

Mr. MORING. Let me answer that. It is the former, not the latter.

The CHAIRMAN. So, it would be a rate differential aggregating $25 billion?

Mr. MORING. Yes.

The CHAIRMAN. As I recall the evidence, the producers' wellhead revenues are somewhere in the range of $50 billion a year——

Mr. MORING. $76 billion was the 1982 number.

The CHAIRMAN. Was that the producers' wellhead revenues?

Mr. MORING. Yes, sir, that is my understanding.

The CHAIRMAN. I think that you are using a wrong definition, but I will check the record. My information is that there is a $76 billion figure, but that is not the producers' wellhead revenue.

But whether it is one figure or the other, if you are talking about one action that would reduce those revenues by $25 billion a year, that is either one-third of their total gross revenues, or one-half of their gross revenues, whichever of those figures is correct.

Mr. MORING. That is true.

The CHAIRMAN. If that is the case, wouldn't they seek price adjustments in some other manner to maintain revenues enough to carry on the business that they are trying to carry on?

Mr. MORING. It is hard to predict what they would do, Mr. Chairman.

I think what we are saying is that those who would be affected would tend to be those with reserves of old or flowing gas; and their revenues per unit of delivery of old flowing gas would be less under the scenario we are assuming than they would be without it.

Now, to the extent they would be less—and let's say it is $25 billion—and to the extent that we are today, poised at something people were characterizing as "the market clearing place, on the average, nationwide," then I think it follows that the $25 billion that was seen in rate reductions to the old, flowing gas sellers would be available in theory as a reward for those who would search for and bring to market new discoveries of natural gas, and that would be, you know, the trade-off that we would be making as a nation were we to move in this general direction, is to say that we would rather put our money in the hands of the new people, the people that buy new gas, than we would revalue the inventory of the flowing gas sellers or continue the——

The CHAIRMAN. Of course, I understand that argument. That is a familiar one, and that is one of the policy considerations that we must try to address here, as well, because if you increase the ability to market high-cost gas, we have seen under NGPA the trend to bring the highest cost gas to the market, because it could be rolled in against the low-cost gas. That gave to the pipeline companies, and to consumers, the opportunity to keep a contract for supplies from Algeria, at over $7 per MCF.

Mr. MORING. This is true.

The CHAIRMAN. If they hadn't had the old gas, they wouldn't have made those contracts.

I am having a lot of people come around here telling us in one place or another—"What kind of damn fools the pipelines were to have signed those contracts."

Would you agree that they were?

Mr. MORING. I don't know enough about the individual circumstances. I think that is a question of—was that a prudent event or not, and I think, in order to assess prudence in any given transaction, one needs to apply all the kinds of factors that you go with, in a reasonable man, reasonable person kind of case, at law.

Mr. McGrath. Mr. Chairman, could I make a comment on your statement?

The Chairman. Yes, sir.

Mr. McGrath. The fact of the matter is that the most of your—the predominant share of your high-cost gas purchases have not been made by the companies with the high-cushion gas.

They have been made predominantly by the companies with the little cushion gas who were really looking for additional reserves, and you must recall that the LNG deals, for example, were signed in the early seventies, and the late sixties.

At that time, this country was on a path to very serious economic disaster because of the situation—the reserve situation that we had, and judgments were made then that if we didn't get these new sources in, we could be in terrible straits; and it was the companies that were low on gas reserves that did the buying.

So, the assumption that these companies had a lot of cushion to roll in their costs is basically erroneous.

The Chairman. Do others of the panel agree with that statement, or have any other comment?

Mr. Cooper?

Mr. Cooper. Well, I was going to say this, sir.

I don't take a position pro or con on Mr. Moring's litigation. Let me say that our industry desperately needs a price adjustment. We have to have a price reduction.

If the Congress is going to hear all the equities in these cases, and try to decide these issues as a basis for that reduction, they will still be sitting here in 1985, trying to figure out which way to go, and what we would like to see you do is to do something that you can do right away and practically, without weighing and trying to ferret out all of the pros and cons of how this litigation should be settled.

The Chairman. Mr. Rodemann.

Mr. Rodemann. Mr. Chairman, with regard to the LNG question, we must not forget that in the year 1968 or 1969, the production of natural gas exceeded the reserve addition, and the El Paso project, for example, was conceived because it was envisioned a desperate need to get supplies.

Sir, you mentioned a price of $7. I recall that when the contract was signed around 1970 or 1971 or so, the price was 87 cents per million Btu in Elba Island, and naturally when the deliveries from Algeria stopped 2 years ago, it was because of a price argument, and I believe ERA approved about $1.50 or so; and we must also remember that a lot of energy industries—also the natural gas industry—hung the wagon on the increasing costs of oil for a number of years, and you may have seen that a lot of costs and prices were beginning to follow the increased cost of oil.

I don't think the industry has envisioned a declining cost of oil, and this causes some of the problem.

If I may just say one more thing, as a principle—if the question is raised, as Senator Heinz asked earlier—what effect it is going to be in the price escalation in gas, or deescalation in gas, when you deregulate old gas?

I submit to you if you don't do anything right now, the cost to the ultimate consumer, to the heating customer, to the cooking customer is going to go up right now, because of the market problems.

So there has got to be a solution, definitely.

Mr. LAWRENCE. Senator, just to confirm what Mr. McGrath said, the LNG contracts were executed 10 to 15 years ago, and those projects were originated then. He is certainly right: the aberrant prices were paid more by the people who had less, not more old-gas cushions.

And I think, also, though, you have seen some real examples of the supply-demand situation working there.

In all of those contracts where market-out provisions were in, they have been executed, and the price is coming down, coming down, dramatically, as Mr. Dage mentioned here earlier.

The CHAIRMAN. Let me address a question to the panel generally. I think I can anticipate, at least, what Mr. Moring will say in answer to this question.

Can FERC address the current problems in the gas market under existing authority?

Mr. Lawrence?

Mr. LAWRENCE. They had begin to initiate rate design proceedings, which we think will help transmit the market signal from distributor to pipeline to producer.

It might well be that there could be some statutory impetus there.

The CHAIRMAN. If we just sat and did nothing, can they take care of it under existing authority?

Mr. LAWRENCE. I think they are going to—I think there is going to be, there is a tremendous momentum to change the fraud and abuse standard, I think, to something that would include the prudence.

And I think there is an impetus, whether it is at FERC or whether it is conferred by statute, that the rate design proceeding at FERC be more responsive to current market conditions.

The CHAIRMAN. Mr. Zeigler?

Mr. ZEIGLER. I think from my experience, FERC—I think we probably will see more rate cases, for example, or general rate cases that will go to hearing rather than to settlement, and I think more light may be shed on practices, and I think whatever additional guidelines are needed could be enacted.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. I agree with Mr. Zeigler. We would like to see the Congress address this, and tell the Commission to get on to the job.

The CHAIRMAN. Mr. Rodemann.

Mr. RODEMANN. I appreciate the question, Mr. Chairman. I think unless FERC gets a strong signal, a new direction, not much is going to happen. I submit to you that in the recent *United Pipe Line* case where United filed for a minimum bill provision there had been motions from Intervenors and staff to summarily dismiss and sever the minimum bill provision which was basically a take-or-pay provision that they put into the tariff October 1 of last year; and the Commission, as well as the administrative judge were unresponsive to those requests, even though there is a financial burden on all the gas users at this instance.

In our case, we are paying 25 cents per MCF just on United's rate—in fact, that became effective October 1 on a take-or-pay or referred to as "minimum bill."

Now, the carrot may not work, Mr. Chairman; there may be a stick necessary.

The CHAIRMAN. Mr. McGrath.

Mr. MCGRATH. No; if it were otherwise, Mr. Chairman, I would not be here if I thought that legislation were not needed and FERC could do the job.

The CHAIRMAN. Let me ask one other question because, I think this bears upon, not only what the answer should be, but perhaps what kind of an answer we should be seeking.

In 1977 and 1978, as we were enacting NGPA, we were acting against the backdrop of the conventional wisdom of the time that there was a shortage of natural gas, that the demand exceeded supply and would likely continue to exceed supply.

Today, as we sit here, a great many people are telling us that there is not only a world glut of oil, but there is a domestic oversupply of natural gas.

We have heard a number of witnesses tell us that they have gas which they would like to sell, but they can't find a market for it, and I assume that regardless of how that may be distributed, or how it may be located with reference to a natural gas pipeline system, that there is at least some awareness on the part of all the panelists, that there is some gas out there seeking markets that cannot now find the market.

If that is the case, and I will invite you to disagree if you don't think that is the case—but if that is the case, how long do you think we will have an adequate supply of gas—how long can we confidently expect that the supply-demand relationship that we perceive in the market today will continue?

Mr. Lawrence.

Mr. LAWRENCE. Mr. Chairman, we estimate that the current oversupply is about 2.7 trillion.

As to how long that would last, there has been a so-called gas bubble since the NGPA was passed. That was shortly after 1978, and the intrastate supplies were made available.

It, of course, depends upon the ability to recapture our industrial markets, and to permit in growth of the industrial markets new demand opportunities to be darn sure we don't do away with our new gas exploration incentives that the NGPA has showed us will work so well.

And that is why it is so important that we have this orderly transition, to a deregulated new market. I guess I misunderstood your question a moment ago. I have listened to so much rate design and FERC discussion here that I am getting a little numb.

If you mean can the FERC solve the current transition in pricing problems, then my answer, like Mr. McGrath's—Certainly not, or we wouldn't be here.

We do need the take-or-pay alleviation; we do need the indefinite escalator relief; we do need some incentives to renegotiate market-out, certainly, the high-priced contracts, to give people a chance to look at what is marketable today.

The CHAIRMAN. Mr. Zeigler.

Mr. ZEIGLER. I think I—I believe I could speak for the distributors' group from the standpoint that we do believe in alternate decontrol at the wellhead.

The CHAIRMAN. Yes.

Mr. ZEIGLER. It took us a long while, probably, to get to that point. If we agree on anything, I think most distributors, if not all, say that ultimately, gas should be decontrolled.

We have discussed the old gas—I don't want to reopen that keg of worms again, but basically I do think that from what we can understand this surplus will continue for the next several years anyway, that there are unproven reserves that are adequate for many, many decades, several, three or four—you name it.

So, that the potential is out there to have adequate gas supplies during this decade. What comes beyond will depend upon the price of a deregulated supply, what the market can bear.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. Mr. Chairman, if prices keep going up the way that they now are, and if the price redetermination clauses hit us in 1985, we have a 20- or 25-year supply, but there will be no market. And on the other hand, if we get prices down to where they should be, so they are at market clearing levels, then we are looking at a period when there must be new supplies developed, and that is not too far off.

The CHAIRMAN. How many years?

Mr. COOPER. Well, I think that it varies with the pipelines. But I know that various pipelines need lots of new gas coming into their system in 3, or 4, or 5, years from now. And so if you get the market back where it should be, then we need to get some new supplies.

The CHAIRMAN. Mr. Rodemann.

Mr. RODEMANN. Mr. Chairman, I believe that there are going to be supplies beyond the year 2005. I make this statement not in a frivolous manner, but for this reason. Years ago when I started in the gas business digging ditches 25 years ago, the gas industry saw a need to have a 20-year supply on the books, or they would not be comfortable.

In 1970, our suppliers had told us we have a crisis, we are going to find out in 10 years. Sir, I submit to you that this is 13 years later, and now we are told that we have only 6 years supply.

I believe that the ingenuity of the industry will find the reserves that are there. Naturally, attorneys and ratemakers always play with the term "proven reserves." It is a favorite term in rate cases. Because if you can prove that your reserves are low, you can apply for a higher depreciation rate on your system, which is a nice scheme.

So you cannot believe everything that people say with regard to reserves. The reserves will be there to allow a free market, and I believe that, Mr. Chairman.

The CHAIRMAN. Hear! Hear!

Mr. McGrath.

Mr. MCGRATH. Well, I guess that I could spend a little time here arguing with Mr. Rodemann, but I will try to answer your question, Mr. Chairman. I think that you must recognize that the surplus that you have referred to is a surplus in deliverability. And that means the amount of gas that is available, that could be taken by the pipeline companies from the producers, and is not being taken because of a variety of circumstances, not the least of which is a recession, the drop in oil prices, conservation, and so on.

And in my statement, my full statement, I have shown the results of a survey that we are conducting at this time. You have heard from about 15 of our companies, which represent about 60 percent of total supply.

And they show that in 1983, they estimate a little over 2 trillion cubic feet of surplus deliverability. In 1984, that drops down to about 1.3 trillion cubic feet. And by 1985, they are estimating about a half a trillion cubic feet, or 500 billion cubic feet. That is consistent with our earlier projections, that we think that the surplus and deliverability only has about 2 to 3 years left.

And I think that it is very important to realize that we are not talking about reserves. And we think that the reserve additions are going to have to be improved, if we are going to be able to continue to render the kind of service that we are obligated to render, and which this Nation needs.

And that is one reason why we are very, very concerned that any legislation that the Congress adopts looks not at just the crisis that we have today, but looks down the road into the future, and to create the incentives that are needed to get the drilling activity going back again to start developing the reserves to do the wildcat drilling, the development work that has to be done to bring in new reserves, to discover new reserves.

Now today, there is not much gas being brought by the interstate pipelines. The markets are so soft, particularly because of the drop-off in industrial sales, that not many pipelines are buying gas.

The consequence of that, as you have probably heard in this hearing, and certainly today from the producers, that the rig count is down dramatically. No one is really out looking for gas to any great extent, not nearly what it used to be. And if that continues, then the reserve situation down the road is going to be very, very serious.

Mr. LAWRENCE. Senator, very briefly, the resource base as recently estimated by the Potential Gas Agency is in the range in the lower 48 States of about 750 trillion cubic feet. So when you add in the proved reserves, that is potential, so when you add in the proved reserves, the proven potential and resource base of natural gas is over 900 trillion cubic feet.

That does not take into account the tight sands, the Devonian shale, the new technology breakthroughs, that there are tremendous potentials for that can boggle the mind. There is no resource base shortage in this county.

And I think that the one thing that the NGPA did was to lay to rest that shortage doomsday mentality, and I certainly hope that it is not revived here again in these hearings. Because the potential is there. We do need the new gas incentives.

The CHAIRMAN. I recall, too, that I think within the last month the Canadian Energy Board has resurveyed their demand-and-supply situation, and has indicated that they are willing to double the amount of gas committed to export markets.

That would certainly not be counter to the evidence from the producing Provinces that they have a lot of resource that they want to commit to the market. It has not yet been reflected in any price adjustment, however.

Mr. **Lawrence**. I purposely did not mention Canada and Mexico, because of the controversy and discussion earlier. But it is a North American secure supply easily brought into our million-mile system, and far, far preferable to oil imports.

The **Chairman**. Well, I do not disagree with the statements that have been made. Mr. McGrath is most cautious about it in terms of deliverability in the short term. Mr. Rodemann perhaps is the most optimistic about it in terms of the ability and the ingenuity of the industry to get there.

One of the things that I guess I should say, and I do not know whether it is a comment or a question, or perhaps a question or a comment, but if you really believe that those supplies are there and adequate, why do you fear so much having to negotiate for contracts?

Mr. **Lawrence**. You mean pursuant to the administration bill of the January 1, 1985, negotiation of everything?

The **Chairman**. Yes.

Mr. **Lawrence**. We just think that it is totally unnecessary. That is not the pricing problem. The pricing problem is the escalator clauses, the contractual obligations, and the prices that came about in a period——

The **Chairman**. If we get rid of those, you can negotiate for the balance?

Mr. **Lawrence**. We do not see the supply incentive to subject anybody to mandatory renegotiation, or to an automatic market out for everybody on the old gas. Renegotiation of old-gas contracts certainly may be something else. But the mandatory right that permits the producer to opt out is what concerns us.

The **Chairman**. I understand that. And certainly, it will have to be balanced on both ends. You cannot get stuck with rising price on one end of your supply, and no availability of lower cost on the other end.

But if you have a market out on all of your high costs, it seems to me that the real hazard lies with the high-cost producer. The high-cost producer is the one who is going to take it in the neck.

Mr. **Lawrence**. Well, they already are. And they are negotiating their contracts downward. They are being marketed out. They know that that is happening. Mr. Gage said that they are selling new gas deep and new gas other right now between $3 and $3.30. That is a far cry from the $8, $9 contracts, the aberrant contracts that we saw earlier.

The **Chairman**. Some of them as high as $10.

Mr. **Lawrence**. Yes.

The **Chairman**. Mr. Cooper.

Mr. **Cooper**. I think that our fear is this, Mr. Chairman. If you throw everything up for grabs in a very short period, it is just almost inconceivable that the pipelines can work it out, and do all of its renegotiating against all of the pressures that are going to be put on them, and grabbing supplies here, and grabbing it there, and be anywhere near assured in January 1, 1986 that you are going to have an average price anywhere near the market. It could be way above the market.

The CHAIRMAN. Or way below?

Mr. COOPER. I cannot imagine it being way below with all of the bargaining power of the producers.

The CHAIRMAN. I cannot imagine it being way below the market either. I am quite sure that I understand how if you are free to negotiate on all of the high-cost contracts and low cost, and market out of the ones that you do not like, and if there is an oversupply in the market you can go out and bid for supplies—now certainly, it may not be that those supplies are positioned correctly, and it may be that a pipeline cannot negotiate with producers because there will not be enough producers in the particular area where that pipeline operates.

I can understand the concern that some have expressed that maybe the big integrated oil companies have enough economic staying power, that they can just wait out the period, and wait until they can negotiate upwards their low-cost gas, their old flowing gas. But at precisely the same moment that that happens, they also cannot sell their high-cost gas.

Mr. COOPER. If I could comment briefly on that, Mr. Chairman.

The CHAIRMAN. Yes, sir.

Mr. COOPER. We are concerned about the rather massive shock to the system, if you will, by the wholesale renegotiation of contracts and marketing out. We would not hope that renegotiation would not take place. We would hope that to the extent that some of these high-cost gas contracts could be renegotiated, that they would be.

But I guess that our major concern with the administration's approach is suddenly by January 1, 1985 or between date of enactment and January 1, 1985, all of these literally thousands and thousands of contracts would have to be renegotiated.

And if they are not renegotiated by January 1, 1985, then there is an automatic option on either seller or buyer to market out. And this could have a very disruptive effect on the total structure of the industry.

We can envision, for example, many producers electing to market out with some intrastate or end-user buyers standing in the wings waiting to latch onto that. And if you couple that with the limitation in the PGA passthrough, which the administration's bill would put on the interstate pipelines, they are hamstrung in competing for it really, unless they are faced with the delays and uncertainties of the FERC review, why the interstate pipelines, we think, could be very, very seriously disadvantaged by that kind of event.

Mr. LAWRENCE. Senator, very briefly, while you were out, I used a couple of numbers that we believe and we think that over the next 3 years, if the old gas is optioned and marketed out in January 1, 1985, in the following 3-year period, there would be about a $20 billion transfer to the producers of old gas.

Now somebody is going to pay that. The administration says new gas producers will negotiate downward, and it will balance out. We do not believe that entirely. We think that there is going to be a sticking point. We think that it is going to be a lot harder to negotiate that down.

But assuming that they are right, then the consumers are going to pay it. Somebody is going to pay that transfer of $20 billion over the next 3 years. Either that, or they are going to try to take it out of the hides of the pipelines, and the rigid PGA ceilings. And there ain't that much there in the pipelines.

The CHAIRMAN. I can understand why you get nervous at the prospect.

Mr. LAWRENCE. Right.

The CHAIRMAN. Mr. Zeigler.

Mr. ZEIGLER. One other comment I had was that we get somewhat nervous with our financial people when we cannot say we have a good contract supply in the future. And it then downs the quality of our investment, and makes it more difficult and more expensive for us to borrow capital.

The CHAIRMAN. I guess that we will call on Mr. Dole to solve that problem.

Mr. ZEIGLER. I hope so.

The CHAIRMAN. I have no further questions.

Mr. Rodemann, do you have a comment?

Mr. RODEMANN. Yes, Mr. Chairman, if I would be allowed closing arguments. I hear a lot of billion dollar figures floating around. And the next question remaining is what if the sky falls. I submit to you that there is going to be a sunrise in the morning.

But I also say that if you do not do anything, if you hold status quo, my customers, my residential customers, the underprivileged, and many of them get Federal tax dollars to pay their gas bill, their cost is going to go up in the neighborhood of 60 to 80 percent because of the loss of industrial sales with further loss possibly coming with the drop in oil prices when our business goes down the drain to No. 2.

Now that is here today, and that is what we are faced with. And if I may so bold as to ask for one more sentence. I said earlier that the gas industry had lived a sheltered life for many years. For better or worse, but somebody, Big Brother, took care of them.

We also took care of them, because we had to look for alternate sources for large peak serving facilities to support their survival. And right now, the industry has to wake up, and say well, this is a new ball game. They have to get away from the protected life, positive or negative, and go out and hustle. I rest my case.

The CHAIRMAN. Thank you, very much, all of you, for your patience as well as for your very good testimony and your responses to questions.

I wish to announce that the hearing tomorrow will open in this room at 9:30 a.m. We are in recess until that time.

[Whereupon, the hearing was recessed, to reconvene on Saturday, March 12, 1983.]

NATURAL GAS LEGISLATION

SATURDAY, MARCH 12, 1983

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-106, Dirksen Office Building, Hon. James A. McClure (chairman) presiding.

Present: Senators McClure, Domenici, Warner, Hecht, Heinz, Ford, Metzenbaum, Melcher, and Bradley.

Also present: Charles A. Trabandt, chief counsel; E. David Doane, deputy chief counsel for energy; Howard Useem, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. JAMES A. McCLURE, A U.S. SENATOR FROM THE STATE OF IDAHO

The CHAIRMAN. The committee will come to order. The hearing today is the fourth and final session of the committee's hearings on pending natural gas legislation.

By extending this 4-day hearing through today, the committee has been able to accommodate all requests to testify. We will have sufficient time to review all of the testimony and to analyze the responses to followup questions prior to making judgments on the pending legislation.

Our first witness this morning will be Mike Butler, Chairman of the Federal Energy Regulatory Commission. He will be followed by a panel of five witnesses representing a variety of State regulatory agencies. Included in this panel is the National Association of Regulatory Utility Commissioners, an organization that has been closely following the natural gas debate and has recently developed its own proposal for dealing with the issue.

The remaining three panels consist primarily of a number of individual companies within the natural gas industry as well as other companies that sell competing fuels.

Before we hear from our first witness, I note that during the past 3 days of hearings the Federal Energy Regulatory Commission has been the object of considerable comment, not all of which has been totally complimentary. Today the Commission has the opportunity to respond. Of particular importance is the Commission's answer to the allegation that it has not fully exercised its authority under existing law to take certain actions that would reduce natural gas prices.

I would also note that the Commission is well-informed about the current conditions in the natural gas market. Such information is essential to our development of a complete hearing record, and it also relates directly to one of the other fundamental questions in this hearing—what would happen to gas prices and future gas supplies if the administration bill were enacted? The Commission's response to that question will be of particular interest to the committee.

As I mentioned in my opening statement when these hearings commenced on March 9, we must not lose sight of the fact that the fundamental objective of any natural gas bill must be to achieve a balance between the need to limit consumer gas prices and the equally important need to insure that gas shortages do not occur later in this decade.

We must also avoid enacting legislation that does nothing more than compel gas consumers in the long run simply to exchange one form of economic hardship for another.

Senator Metzenbaum, did you have a opening statement?

Senator METZENBAUM. Just a brief one.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. Mr. Butler, we have enough problems with the Federal Energy Regulatory Commission and your actions in connection with gas. Within the last day or so, FERC made a decision having to do with electric rates as well, and I don't know which one to get more upset about, either that one or the decisions you have been making in the area of gas. I can only say to you that the Federal Energy Regulatory Commission in my opinion has totally let down the American consumer. This most recent action—was it yesterday or the day before—confirms that the people of this country, must sit with trepidation and concern on almost an hourly basis as to what new decision you are going to come out with. Inevitably, it seems your decisions make their ability to exist or to live more difficult. As the questions develop, I am going to explore with you what you envision as the role of FERC vis-a-vis the competing interests, between those, on the one hand, who are the sellers, the producers, and others in the industrial mainstream, and these on the other, the consumers. I have searched the record and have had great difficulty in finding any single instance in which a decision of yours was helpful to the average Joe out there in America, and I would like to explore that subject with you because it is disturbing to me. There seems to be an imbalance in your agency at the present time.

The CHAIRMAN. We have your prepared statement, Mr. Butler, and your prepared statement will be placed in the record in full together with the attachment thereto which is a part of that statement.

I would invite you to summarize, highlight that statement in whatever manner you would prefer. You may proceed. If you would introduce the people you have at the table with you?

Chairman BUTLER. Thank you very much, Mr. Chairman. I will start off by telling Senator Metzenbaum that I am prepared to discuss with him the subjects in which he is interested.

I have with me on my right——

Senator **Metzenbaum**. Could you bring the mike up closer?

Chairman **Butler**. Yes, sir. With me on the right is Charles Moore who is our general counsel, and on my left is Robert Means who is our Director of the Office of Regulatory Analysis.

They have both been extremely helpful to me in preparing the testimony and in developing the Commission's policy in connection with regulatory matters over the last couple of years.

STATEMENT OF HON. C. M. BUTLER III, CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION, ACCOMPANIED BY CHARLES MOORE, GENERAL COUNSEL, AND ROBERT MEANS, DIRECTOR, OFFICE OF REGULATORY ANALYSIS

Chairman **Butler**. What I would like to do is to make certain points, and as you have suggested, have the statement placed into the record as if read.

The first point that I would like to make is this. We have all found it very easy to criticize the Natural Gas Policy Act. It is true that the NGPA has failed to work perfectly, and I think we all admit that. But fairness dictates that it be given credit for the good that it has done as well.

It has proven at least two things that were hotly disputed at the time that piece of legislation was passed. First, it has proven that supply will increase in response to increases in price.

Second, it has proven that substantial conservation occurs in response to increases in price. In my opinion, those lessons have been very valuable to us. However, the NGPA—largely because of assumptions which have not continued to obtain—is broken and the time has come to fix it.

The second point that I would like to make is this. I would like to highlight the importance of a rapid and comprehensive resolution of the problem. The FERC has direct control only over prices for tight sands and old gas, and only in the case of tight sands gas can the Commission adjust prices downward.

In that connection, we have already issued a Notice of Proposed Rulemaking which has proposed a floating cap that would reduce, under current economic circumstances, the price of tight sands gas. We do not have such an authority with respect to other statutory categories within the NGPA.

At the same time, section 601(a)(1)(b) of the NGPA explicitly relieves the Commission of jurisdiction over contracts covered by sections 102, 103 and 107 of the Natural Gas Policy Act. Those are the problem contracts. The NGPA operates simultaneously, as I have testified before, as a system of implicit price supports for above-market contracts, and it also operates as a system of rising floors under gas prices for other categories of gas.

The problem of disorder created by that pricing policy were bad enough. They have been vastly aggravated once oil prices began to fall while gas prices continued to rise. The reason is simple. Oil products are the alternative fuel. The alternative fuel price has declined. Gas has thus begun to lose markets.

Most of the decline in gas sales so far appears to be the result of the recession, conservation, and a warmer than normal winter. Fuel switching may well not have contributed substantially to declines up to this point, and the Commission is now estimating that fuel switching could cause the additional loss of one and a half to two trillion cubic feet of sales in the next 6 months if oil prices continue to drop and nothing is done about the Natural Gas Policy Act.

If we are correct and Congress is unable to act within that time, the result will, in my opinion, be a disaster in the Nation's gas markets. So far there has been little if any renegotiation of above-market prices for gas, so consumers will experience further increases from wellhead prices because the NGPA tends to ramp those prices up. They will also have to bear the additional burden of fixed costs that were paid by those who switched fuels.

From a supply standpoint, that means that the surplus deliverability in the market will just about double. As a consequence, producers will stop drilling because they cannot market their gas. Since we expect relatively sharp declines in deliverability from the gulf coast after 1985 or 1986, the prospect is for new shortages, even higher prices and a return to rationing.

Those are the stakes that are implcit in Congress decisions to act, and these factors hopefully militate against the possibility of a stalemate in the Congress on these issues.

Third, Congress has been hindered in coping with the problem by powerful and numerous special interests with large stakes in what amounts to a statutory system of preferences and advantages. Let's start with the producers. Major oil companies do in fact own about 70 percent of the old gas that could be repriced upward under S. 615. They have, therefore, an obvious interest in old gas price decontrol.

Deep gas producers have just as obvious a stake in the Natural Gas Policy Act because it provides price supports for their above-market prices for their production. For example, one of your witnesses was Mr. Heffner of GHK. GHK could not charge prices in excess of $6 for its production without gas price controls. Neither could Slawsen Oil Co. of Wichita, Kans., which owns a lot of sections 102 and 103 gas, but has little old gas production. S. 615 would roll their prices back. My estimate is that the aggregate effect of the rollback would be on the order of $1.75 billion soon after the bill becomes law.

The same thing is true of distribution companies like LaClede Gas Co. of Missouri and our own Washington Gas Light. Both of those companies are also deep gas producers. LaClede, for example, sells its deep gas to Mississippi River Transmission Co., its sole supplier, for more than $6 an Mcf, but it buys it back at Mississippi River's system average cost which is considerably less.

As to pipelines, many pipelines were involved in exotic gas projects. For example, Trunkline's $7 plus LNG, could not be sold without the advantage of old gas price controls operating as price supports. The same thing is true parenthetically of Canadian gas priced at $4.94 a million Btu's at the border. Michigan-Wisconsin must be concerned with its ability to market the $6 plus gas that will be produced by the Great Plains coal gasification project. Owners of the Northern Border Pipeline who cannot market Canadian gas without the price supports implicit in old gas price controls must also be concerned.

For example, United Gas Pipeline Co. who does not have much in the way of price supports has just been forced to reduce its gas supplied by Northern Border from 325 billion cubic feet per year to 175 billion cubic feet.

Finally, we have Northwest Pipeline which testified yesterday. Besides being involved in the western leg of the prebuilt portion of the Alaskan gas project which has the same difficulty marketing Canadian gas as the Northern Border Line, Northwest is the prime sponsor of the Alaskan gas project. Overall $1 billion has been spent on that project which under the current law cannot be recovered unless the pipeline is completed and becomes operational. But the pipeline cannot be completed without old gas price controls as a system of price supports. One wonders what the price of that gas would look like in comparison to the gas that is being sold by Trunkline in their LNG project.

In any event, Northwest has an obvious and very large stake in price supports provided by old gas price controls. One important aside is that a former Federal Power Commissioner, Rush Moody, has provided an analysis of S. 615 for his client, Northwest. It was attached to the Northwest testimony. I understand because I am a lawyer that lawyers are paid to represent their clients, and Mr. Moody's analysis should be viewed in that light and not clothed with the trappings of the public interest. For those who wish to see the difference between his views when representing powerful and rich special interests and those when he represented the public interest, I recommend a reading of his dissent in the Columbia LNG case. I would also recommend a reading of his dissent in FPC opinion Nos. 699 and 699H.

I would like to quote one brief paragraph from the Columbia case:

> Only one force can effectively operate to hold down the cost of foreign supplies. We must have vigorous and effective competition from domestic producers, and we must, therefore, return to the discipline of the marketplaces, the basic tool of consumer protection. Decontrol of domestic gas prices through amendment of the Natural Gas Act is now necessary.

That will be found at 47 Federal Power Commission 1653.

Senator METZENBAUM. Mr. Butler, I didn't quite follow you as to the interest of the Alaskan Natural Gas Pipeline development and their position in relation to matters before this committee. I understand they are opposed to S. 615, but I am not quite sure how it affects their economic interest. I wonder if you would be good enough to clarify that for me?

Chairman BUTLER. I would be happy to do that, Senator. I could either complete the last page or so of my testimony and return to that as a question, or I will answer it now.

The CHAIRMAN. Why don't you go ahead and complete your statement?

Chairman BUTLER. I will come back to that because it is an extraordinarily important issue.

I can go on with examples of that sort. However, I don't think that that would be particularly useful considering the committee's limited time. The NGPA in many respects unintentionally provides a very substantial system of preferences and advantages. It has developed around it a very, very substantial special interest following. I think that it is critically important in the committee's deliberation of these issues that it set aside the special interests that you have frequently found represented before you and work hard to find where the public interest really lies.

The final point that I would like to make is this. I would like to deal directly and specifically with the charge that the FERC with its three producer State members cannot or will not follow congressional directives embodied in the law.

In Senator Metzenbaum's opening statement he referred to the fact that three of the members of the Commission are from producing States. Incidentally, so are the other two. Both New York and California are also gas producing States.

The Senator also recites that the Commission has done a number of things that he believes are wrong. They include, among other things specifically mentioned in the statement, area rate decisions of the Commission, the tight sands order, and the stripper well order of the Commission. What I would like to do is look at the record for a moment. Those decisions were made as follows: On area rates, Order 23, commissioners voting, Chairman Curtis, Commissioners Smith, Sheldon, Holden, and Hall; Order 23A, Curtis, Holden, Hall, and Sheldon; Order 23B, Curtis, Sheldon, Holden; as to stripper wells, Order 44, Curtis, Hall, Sheldon, Holden; Order 44A, Curtis, Hall, and Holden; as to tight sands gas, Order 99, Curtis, Sheldon, and Hall.

None of the three producing State members currently a member of the Commission voted on any of those orders. In short, the decisions were made by Commission members who were appointed by the Carter administration and not by this administration.

What I would like to suggest to the committee is this. First of all, I am not criticizing my predecessors on the Commission. My own distinguished predecessor was on that Commission, and frankly I agree in large part with the decisions that were made in those cases. In retrospect, I think there are some things that I would change, and I suspect there are some things they would also choose to change.

I only suggest this. The problem that we have before us is not a Republican problem. It is not a Democratic problem. It is not a liberal problem. It is not a conservative problem. It is an American problem, and it deserves an American answer. Partisanship can play no place if we are to find a solution for the long run to these problems.

We were also criticized by Mr. Moring in his statement. He is an expensive lawyer representing his group of special interests. He claims that the FERC could lower consumer costs by $25 billion by revising its area rate determination, its production-related cost orders, and its Btu adjustment ruling.

I must say that the dollar figure he recited is absurd. I will be more than happy if an analysis of it is provided for record purposes to provide the Commission's judgment as to where and why it is wrong.

Additionally, just as our distinguished predecessors on the Commission did, the present Commission has sought diligently to carry out the law as we find it, regardless of whether those who appear before us like it. That seems to me mitigates very strongly in the direction of the Commission's being able to discharge the responsibilities that the Congress chooses to invest into it.

I would also note in vindication of my predecessors on the Commission that appellate court judgment as to what the law is supports their reading, and quite frankly, Mr. Chairman, it is my belief that with respect to the orders the Commission has issued in connection with production-related costs and other matters that have come before us, that the courts will also find that our reading of the law is careful, measured, and a proper exercise of our judgment.

I feel prepared to deal specifically with each individual allegation that the Commission has failed to do its job. I will be happy to answer questions in connection with that.

[The prepared statement of Chairman Butler follows:]

STATEMENT OF
C. M. BUTLER III
CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

March 12, 1983

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for inviting me to testify today. At the outset, let me commend the Committee for its expeditious consideration of this very important bill.

There are two points which I want to make as strongly as I can before discussing the Administration's proposal. The first is that the rules governing natural gas prices must be changed, and they must be changed soon. Statutory price ceilings maintain the price of some gas at a fraction of its value, distorting decisions by producers and consumers and by distribution and pipeline companies. The most urgent problem, however, is that natural gas prices are now on average too high. They are above the level needed to balance supply and demand on many pipeline systems today; within the foreseeable future they will be above the market-clearing level on virtually every system. Consumers are being required to pay prices that serve no rational economic purpose; producers with new supplies are finding it impossible to market their gas.

Moreover, pipelines and distribution companies face severe financial difficulties and even insolvency as a result of market losses caused by uncompetitively high natural gas prices. The boiler markets which may switch from gas to fuel oil are very large, perhaps 1.5 trillion cubic feet per year at a minimum. These market losses will further increase prices to the remaining customers, as fixed costs are recovered from a shrinking sales volume.

These problems exist today. They will grow worse in the future even if world oil prices do not decline further; lower oil prices will only further aggravate them.

The Natural Gas Policy Act and the contracts between pipelines and producers contain no corrective. The price ceilings of the NGPA increase monthly with inflation or faster, without regard to market conditions. Virtually every producer contract guarantees the producer at least the maximum lawful price set by the NGPA. Natural gas prices can respond to conditions of surplus supply only if these price rules are changed.

It would be far preferable for the change to occur through renegotiation, but up to this point it appears that there has been very little renegotiation of price between pipelines and producers. The Federal Energy Regulatory Commission lacks the power to revise the contracts except in the case of old gas and tight sands gas, and only with respect to tight sands gas does it have the power to reduce the established price. Tights sands gas constitutes only about 2 percent of the total national supply. The responsibility for changing the pricing rules, therefore, rests on the Congress.

The second point that I want to emphasize concerns the standard by which any legislative remedy must be judged. Later in my statement I will suggest changes in some details of the Administration's proposal. It is important, however, not to expect this proposal to achieve what no legislation can accomplish. No legislation can simply wipe away the past. Investments have been made, contracts entered into, and laws passed on the basis of assumptions about natural gas markets that now prove to be false. The failure to anticipate current market conditions was not limited to any one part of the political spectrum or to any one segment of the natural gas industry. The assumption that supply and not demand was the critical problem was shared by conservatives and liberals, by producers, pipelines and distribution companies, and by consumers, regulators and legislators.

If that assumption was unreasonable, then virtually all of us were unreasonable. Reasonable or unreasonable, however, the decisions made on the basis of that assumption must now be corrected. The corrective process will not be easy and it cannot be entirely smooth. The best that can be asked of any legislative remedy is that it strike a reasonable balance among the affected interests and that, in the end, it lead to institutions that assume not continuing surplus or continuing shortage but rather continuing change and uncertainty. I believe that the Administration's proposal meets this standard.

Perhaps other proposals would do so as well. But it is imperative that the Congress not delay action while it searches for an easy and painless solution to the current natural gas problem. No such solution exists.

I would now like to turn to the Administration's proposal. Its provisions are directed at two goals. The first is to move the industry to rational market-clearing prices. The second is to encourage a more vigorous and equitable competition for natural gas supplies and burner-tip markets. The provisions dealing with price are likely to be the most significant parts of the bill over the short run. Over the longer run, however, the provisions dealing with competition have the potential for fundamentally changing the way in which the natural gas industry conducts its business. Both sets of provisions, therefore, deserve the most serious study and consideration.

The bill would affect the cost of gas to natural gas consumers in several different ways. It would directly affect the price paid to individual producers by immediately imposing a gas cap or price freeze, by giving both pipelines and producers a statutory market-out clause during 1985, and by ending all statutory price controls by January 1, 1986. It would also affect the average cost of gas to pipelines by giving them greater flexibility to purchase gas from lower cost sources by limiting take-or-pay obligations to 70 percent of deliverability. Finally, it would impose new procedural and substantive limitations on pipelines' ability to pass purchased gas costs through to their customers.

In particular I would like to discuss two of the price provisions that most directly affect the Commission. One is the gas cap: a new price ceiling based on the prices paid under new and newly renegotiated contracts. The other is the limitation on pipelines' ability to pass purchased gas costs through to their customers.

The gas cap is a response to the rigidity of the price clauses contained in most existing producer-pipeline contracts. Those contracts in general allow prices to move in only one direction: up. So long as gas was underpriced, this contractual bias did no harm, and the clauses were in fact a useful means of ensuring that producers received at least the maximum lawful price. But gas is no longer underpriced on average, and these clauses now serve only to insulate producer prices from the rigors of the marketplace.

By far the best remedy for the rigidity of existing price clauses would be for pipelines and producers to negotiate new ones, but substantial renegotiation may not be occurring. Legislative intervention therefore is required.

Two basic alternatives are available for that intervention. One is to give each party to the contract a right to force renegotiation by creating a statutory market-out clause. The other is to impose a statutory limit on the operation of price escalator clauses. Not a fixed dollar limit, since that would simply replace one kind of rigidity with another, but rather a limit designed to approximate the market value of natural gas.

The Administration's bill adopts both alternatives. Both pipelines and producers are given a statutory market-out clause that can be exercised during 1985. Between now and 1986 the price of most categories of gas is limited by the gas cap.

In one sense the gas cap can be viewed as a legislative version of the most favored nation clauses that are contained in many producer-pipeline contracts, but with two important modifications: the gas cap is based on recent national average prices rather than on the highest prices in some region, and the cap would be used to move prices down as well as up. Indeed, initially at least, under current market conditions it would almost certainly be used solely to move prices down.

I believe that the concept of the gas cap is sound. I would, however, like to note some concerns about its operation. My concerns are not with the practical implementation of the gas cap. The time schedule established by the Administration's bill is short, but it does not now appear to be impossible to meet; if some modification in the schedule is required, it should not be large.

Rather, my concern is with the price level that may be established by the gas cap. The purpose of the cap should be to maintain gas prices at a level that accurately reflects the current balance of supply and demand. The gas cap goes far towards accomplishing that purpose; certainly it would be far more responsive to market conditions than the rules now governing natural gas prices. However, I believe that consideration should be given to modifying the set of prices on which the gas cap is based.

In its present form the gas cap is based on two kinds of prices: those being paid under recent new contracts, and those being paid under recently renegotiated contracts. Because natural gas is purchased under long-term contracts, only a relatively small part of the supply at any one time is being sold under contracts negotiated in recent months. In today's natural gas market, the relative importance of new contracts is likely to be even smaller.

As a practical matter, therefore, the gas cap may be determined principally by the prices paid under recently renegotiated contracts. Those prices may not accurately reflect current market conditions. Probably they will be too low.

I noted earlier that the Administration's bill will directly affect the cost of natural gas to consumers in a number of direct ways. It will also affect natural gas costs indirectly by establishing the framework within which producers and pipelines renegotiate their contracts.

Consider the alternatives created by the bill for parties considering renegotiation. If they do not renegotiate, the price will continue to be governed by the existing contract until 1985. Then, both the producer and the pipeline will have the right to invoke the statutory market-out clause created by the bill. If the price is above the market level, the market-out clause generally will be invoked by the pipeline; if it is below the market level, it generally will be invoked by the producer. Thus both parties generally would anticipate that the price of the gas after 1984 would be closely linked to its market value if they do not renegotiate their contract. With reciprocal market-out clauses, there is no reason for a pipeline to pay a higher price and no reason for a producer to accept a lower one.

On the other hand, if the parties do renegotiate their contract, the statutory market-out clause does not come into existence. The parties are, of course, free to establish a contractual market-out clause if they choose, but if they do not, the price under the contract will be the one established through renegotiations even after 1984.

Given those alternatives, the bargain to be struck where the gas is now underpriced appears to be different than where it is now overpriced. Where the gas is now underpriced, the pipeline can offer the producer a price that is higher than the one now established by the contract but lower than the market value of the gas. The producer's advantage is an immediate cash flow; the pipeline's advantage is assurance of a relatively inexpensive source of supply even after 1984.

The logic of the bargain is essentially the reverse where the gas is now overpriced. The parties could be expected to renegotiate a price that was lower than the existing one but above the market value of the gas. The pipeline would obtain an immediate decrease in its gas costs; the producer would continue to receive a price higher than the market value of the gas even after January 1, 1985.

The actual bargains struck in renegotiation are likely to be more complex. For example, the parties might include a market-out clause but delay its effective date for some time. However, I believe that the general tendency would be for low-cost gas to be renegotiated at a price that is still below market value and for high-cost to be renegotiated at a price above market value. Those renegotiations are not necessarily unreasonable, either from the standpoint of the parties or from the standpoint of the general public interest. But they do raise questions about the use of renegotiated prices for the gas cap. Since the volume of low-cost gas is now much larger than the volume of high-cost gas, I think that the use of renegotiated prices is likely to give the gas cap a substantial downward bias. The bill's limit on pipelines' ability to pass through their purchased gas costs may, however, make pipelines unwilling to renegotiate their low-price contracts. It therefore is possible that on balance the inclusion of renegotiated prices in the gas cap would in fact tend to increase the level of the cap.

I therefore think that consideration should be given to limiting the gas cap to prices under new contracts. I have to concede that this limitation would create a new problem. Since the amount of gas sold under recent new contracts is small, a gas cap based solely on prices under such contracts could be very volatile; this may be the reason that the bill includes renegotiated prices as well. However, I believe that there may be other ways of limiting the cap's volatility. The use of deliveries for a larger number of months is one possibility; rules explicitly dampening wide swings in the cap is another.

The impact of the cap will depend not only on the level of the cap but also on the price and categories of gas sold by each pipelines. The cap does not apply to gas that is deregulated under Section 107(c)(1)-(4) or for which the Commission has established an incentive price under Section 107(c)(5); the price of these categories of gas is instead frozen at the pre-enactment level. The cap also does not apply to imported gas. It does apply to all other major categories of gas. However, unless the gas cap is very low, it will have no impact on the cost of old gas under Sections 104 and 106(a) of the NGPA.

The principal impact of the gas cap thus will be on gas governed by Sections 102 and 103 of the NGPA. Stripper well gas governed by Section 108 and miscellaneous categories governed by Section 109 probably will also be affected, but the amount of gas in these categories is relatively small.

The impact of the gas cap on each pipeline therefore will depend principally on the relative amount of Section 102 and Section 103 gas that it purchases. The Commission's staff has estimated the impact of the gas cap on each major interstate pipeline under various assumed levels of the cap. Table 1 shows the cost reduction for each pipeline in millions of dollars. Table 2 shows the reduction in cents per Mcf; under the cost-based regulation used by the Commission and by the state utility commissions, this reduction would be passed through to natural gas consumers. For purposes of comparison, Table 3 shows the purchased gas component of the major pipeline's rates in effect in March 1983. A comparison of Table 2 and Table 3 shows that, as might be expected, the reduction in gas costs resulting from the cap is largest for the higher cost pipelines. There are exceptions, however. A pipeline with high average costs due to heavy reliance on imports or Section 107 gas would be less affected by the cap than one with the same average gas costs but larger purchases of Section 102 and Section 103 gas.

I want to emphasize that these tables do not measure the full cost reduction that would result from the Administration's bill. The 70 percent limitation on take-or-pay obligations would allow pipelines to achieve an additional reduction in average gas costs by relying more heavily on low-cost sources of supply; for some pipelines this cost reduction should be substantial. In addition, additional cost reductions could be achieved in 1985 when pipelines are able to exercise the statutory market-out clause with respect to high-cost sources of supply.

I will not attempt to predict the precise price consequences of the bill. Some general conclusions seem to be justified, however. First, the gas cap and the limitation on take-or-pay obligations should permit every pipeline to achieve an immediate reduction in purchased gas costs. Second, it is not now possible to predict whether the average cost of gas at the end of 1984 would be lower under the Administration's bill than it is today. There is, however, every reason to believe that it would be substantially lower than it would be under the existing legal rules. Third, looking further ahead to 1985, the cost of gas in that year almost certainly would be lower under the Administration's bill than it would be under existing legal rules. This should be true both for the national average cost of gas and for the cost of gas to each pipeline. The reason is that the deregulation price clauses now contained in many natural gas contracts are likely to lead to a very large price increase in 1985 under existing legal rules; the market-out right given to pipelines by the bill will permit them to prevent the prices governed by these contracts from going above a reasonable market level. Finally, I do not believe that anyone can predict with any certainty the price of gas much beyond 1985.

The Administration's bill gives producers and pipelines the opportunity to establish pricing rules that will avoid both curtailments on one hand and needlessly high prices on the other. I believe that both producers and pipelines have learned a great deal about natural gas markets in the last year or so; the threat of bankruptcy can be a marvelous spur to education. I think that they will take advantage of the opportunity that the bill gives them.

The bill also limits the ability of pipelines to pass their gas costs through to their customers. I have attached to this statement an analysis of this provision prepared by Commission staff. The analysis is a preliminary one, but it suggests some serious questions regarding this part of the bill.

The limit would be contained in a new Section 603 added to the NGPA. Section 603 would establish two new mechanisms governing pipelines' recovery of their purchased gas costs. First, the section would establish a limit on the rates that pipelines could recover under the Commission's existing PGA regulations. This limit would be based on the pipelines' average gas costs for the month before enactment and would be adjusted for inflation since that month. In my judgment, this limit is basically workable but that its effective date may have to be delayed for 60 days after enactment in order to give the Commission time to issue implementing regulations and the pipelines time to obtain the data on which the limit would be based.

The second new mechanism is a new procedure for recovering gas costs that cannot be recovered within the new limit on the operation of PGA's. This new procedure would limit pipelines' recovery of their costs in two ways. First, substantively, it would replace the NGPA's fraud and abuse standard by a more stringent one: the Commission could allow recovery of the purchased gas costs only if it found that the costs "were just, reasonable, and prudently incurred." In making that determination, the Commission is directed to consider "the reasonable availability of lower cost supplies to the pipeline and the necessity of such cost for the pipeline to render adequate service to its existing customers."

The new Section 603 would also impose new procedural limits on pipelines' recovery of their purchased gas costs. Here in particular it is most important that some modification be made. At present, Section 603 appears to prohibit recovery of gas costs subject to refund pending a final Commission decision and also to prohibit later recovery of costs incurred before the final decision. In addition, it appears that rates would have to be based solely on costs already incurred; pipelines could not base their rates on projected future costs.

These procedural limitations appear likely to have two serious adverse consequences. The first is that the Commission may require substantially greater staff resources in order to process this caseload. The apparent prohibition against basing rates on projected future costs is likely to encourage frequent rate filings. It appears that the Commission could be confronted with literally hundreds of concurrent rate cases under the new Section 603 procedures, in addition to the ordinary rate cases filed under Section 4 of the Natural Gas Act.

The second consequence is that pipelines are likely to find it extremely difficult to obtain full recovery even of purchased gas costs that are found to meet Section 603's substantive standard. This inability may jeopardize the financial health of the pipeline involved. It is impossible at this point to know for certain whether this problem will arise; it will depend on a variety of factors, including the level of the gas cap and the price at which contracts are renegotiated. However, the margin of error is not large. Table 4 gives the major pipelines' net income per Mcf of natural gas sold; Table 5 does the same for their net cash flow. The principal lesson from these tables is that a pipeline's inability to recover even a relatively small percentage of its purchased gas costs could put its solvency in question.

The more serious problem, however, may not be that pipelines will become insolvent but that they will avoid insolvency by measures that do not serve the long-run interests of their customers. A pipeline faced with the danger of incurring gas costs in excess of the PGA limit has two strategies available to it to minimize its current gas costs. One is to discontinue purchases of new gas supplies. The other is to acquire new supplies at a relatively low price by offering producers a large price increase in 1986. The first strategy would force the pipeline to bid more aggressively for supplies in the future, signing contracts and accepting terms that it would reject if its gas acquisitions had been more evenly distributed over time. The long-run consequences of the second strategy are obvious.

These strategies are in effect the ones adopted by interstate pipelines during the 1970's, when federal price controls prevented them from bidding for new supplies on the basis of price. To a considerable extent, interstate pipelines were simply unable to acquire new supplies during that period; one of the results was the feverish -- and costly -- bidding for costly new deregulated gas after 1978. To the extent that interstate pipelines were able to acquire new supplies, they commonly did so only by including onerous deregulation and take-or-pay obligations in their contracts. If this experience is not to be repeated, pipelines must be able to recover those purchased gas costs that do meet the substantive standard established by the Congress.

These problems do not require abandonment of the basic approach contained in Section 603. Natural gas consumers must be assured that pipelines are behaving reasonably and prudently during the transition to rational market-clearing prices. That assurance may require that pipeline purchased gas costs be subjected to a much closer scrutiny than has been possible under the fraud and abuse standard of the NGPA. The assurance should, however, come from the substantive standards imposed on pipelines and not from procedural rules that prevent a full recovery even of purchased gas costs that fully meet those substantive standards. I therefore would recommend two changes in the procedures for recovery of purchased gas costs in excess of the PGA limit. The first is that the Commission be empowered to approve rates based on reasonable projections of future gas costs. This change appears to be necessary if the Commission is not to drowned in a sea of special rate cases. The second procedural change is that pipelines be allowed to recover, in one way or another, legitimate purchased gas costs incurred before the Commission's final decision. This might take the form of allowing the Commission to permit purchased gas adjustments in excess of the allowed rate to become effective subject to refund with interest, but to mandate scrutiny of the excess above the allowed rate. A standard for this review might be cast as a determination whether the pipeline has achieved the lowest cost mix of gas consistent with sound pipeline management, including maintenance of adequate future gas supplies.

I am going to discuss the bill's competitive provisions more briefly. This does not mean that I regard these provisions as unimportant. As I indicated at the beginning of my statement, I believe that these provisions have the potential for fundamentally restructuring the way in which the natural gas industry does its business.

The bill contains three provisions broadening competitive participation in natural gas markets. Section 202 allows any purchaser to bid for natural gas supplies that are no longer contractually committed to a particular pipeline. Sections 401 and 402 give intrastate pipelines broader access to natural gas supplies. Section 403 requires interstate pipelines to carry gas for producers or buyers and provides a substantial economic incentive for them to engage in such carriage.

Section 202 and Sections 401 and 402 deal with significant anti-competitive limitations under existing natural gas legislation. The significance of Section 403 is much broader. It should not be viewed as the solution to any particular problem. Rather, it should be viewed as an enabling provision, one that will allow parties to enter into a broad range of new economic relationships. The form and importance of those relationships will depend on the private parties involved. I believe, however, that Section 403 has the potential for creating a truly national natural gas market that will serve the interests of natural gas consumers and of all segments of the natural gas industry.

I also believe that the combination of legal obligation and economic incentive used by Section 403 is the only practical means to make the interstate pipeline's capacity effectively available to other shippers. Some pipelines are now willing to transport gas that they do not own, but others are not. I see no reason why the unused capacity of the latter pipelines should not be made available, particularly since doing so will relieve existing pipeline customers of a part of the burden of the fixed costs of the system.

However, I am doubtful that the legal obligation to transport could be effectively imposed on wholly unwilling pipelines. For this reason I think that it is important to offer economic incentives as well.

Some additional considerations of the specific form of the legal duty and economic incentives contained in the bill may be useful, however. On the duty, in practice it may not be easy to determine whether a pipeline has excess capacity on a particular route. On the incentive side, I think that Section 403's terms should make it clear that only the consideration in excess of a pipeline's costs should be flowed through to its stockholders; otherwise transportation under Section 403 would be subsidized by a pipeline's resale customers. In addition, I am uncertain at this point whether five cents is the appropriate level of incentive. Both I and the Commission staff will be happy to work with this Committee on these technical questions.

TABLE 1

REDUCTION IN PAYMENTS FOR 'NEW' GAS

PIPELINE	IF ASSUMED CEILING IS				
	$3.50	$3.00	$2.50	$2.00	$1.50
	(millions of $$)				
CITIES SERVICE GAS CO.	2.57	31.83	73.87	122.87	171.87
COLORADO INTERSTATE GAS	.25	20.33	55.84	99.11	142.61
COLUMBIA GAS TRANS.	.91	82.44	220.46	382.50	545.00
CONSOLIDATED GAS SUPPLY	2.41	24.48	55.78	93.82	132.32
EL PASO NATURAL GAS	3.82	78.42	227.24	442.93	669.43
FLORIDA GAS TRANS.	.00	9.63	24.36	41.21	59.21
KANSAS-NEBRASKA NATURAL GAS	.25	3.81	11.22	21.99	32.99
MICHIGAN-WISCONSIN P.L.	.17	41.76	110.71	189.48	268.48
NATURAL GAS P.L. CO.	.42	60.02	161.01	280.94	402.94
NORTHERN NATURAL GAS	.42	52.11	147.65	266.15	384.65
NORTHWEST P.L.	.58	9.93	36.21	79.33	123.83
PANHANDLE EASTERN P.L.	.75	20.04	73.87	158.99	245.49
SOUTHERN NATURAL GAS	.50	53.72	137.47	230.28	323.78
TENNESSEE GAS P.L.	.50	93.97	243.47	410.32	578.32
TEXAS EASTERN TRANS.	.08	41.52	107.09	178.86	250.86
TEXAS GAS TRANS.	.17	25.93	71.40	131.57	196.57
TRANSCONTINENTAL GAS P.L.	.08	158.48	391.87	630.22	869.72
TRANSWESTERN P.L.	.17	23.87	70.21	133.22	199.22
TRUNKLINE GAS	.00	54.70	136.13	222.60	311.60
UNITED GAS P.L.	.75	85.74	224.18	383.38	544.88

TABLE 2

REDUCTION IN AVERAGE PRICE PAID FOR GAS BY
20 MAJOR PIPELINES UNDER ASSUMED PRICE CEILINGS

PIPELINE	ESTIMATED ANNUAL GAS VOLUME	PRICE REDUCTION PER MCF (1)	(2)	(3)	(4)	(5)
CITIES SERVICE GAS CO.	413.78	$.01	$.08	$.18	$.30	$.42
COLORADO INTERSTATE GAS	344.34	$.00	$.06	$.16	$.29	$.41
COLUMBIA GAS TRANS.	902.11	$.00	$.09	$.24	$.42	$.60
CONSOLIDATED GAS SUPPLY	541.36	$.00	$.05	$.10	$.17	$.24
EL PASO NATURAL GAS	1091.4	$.00	$.07	$.21	$.41	$.61
FLORIDA GAS TRANS.	196.89	$.00	$.05	$.12	$.21	$.30
KANSAS-NEBRASKA NATURAL GAS	93.273	$.00	$.04	$.12	$.24	$.35
MICHIGAN-WISCONSIN P.L.	599.3	$.00	$.07	$.18	$.32	$.45
NATURAL GAS P.L. CO.	991.69	$.00	$.06	$.16	$.28	$.41
NORTHERN NATURAL GAS	641.63	$.00	$.08	$.23	$.41	$.60
NORTHWEST P.L.	286.77	$.00	$.03	$.13	$.28	$.43
PANHANDLE EASTERN P.L.	691.31	$.00	$.03	$.11	$.23	$.36
SOUTHERN NATURAL GAS	532.93	$.00	$.10	$.26	$.43	$.61
TENNESSEE GAS P.L.	1132.2	$.00	$.08	$.22	$.36	$.51
TEXAS EASTERN TRANS.	934.21	$.00	$.04	$.11	$.19	$.27
TEXAS GAS TRANS.	635.48	$.00	$.04	$.11	$.21	$.31
TRANSCONTINENTAL GAS P.L.	987.87	$.00	$.16	$.40	$.64	$.88
TRANSWESTERN P.L.	395.03	$.00	$.06	$.18	$.34	$.50
TRUNKLINE GAS	572.94	$.00	$.10	$.24	$.39	$.54
UNITED GAS P.L.	831.87	$.00	$.10	$.27	$.46	$.66

(1) ASSUMING PRICE CEILING FOR SECTION 102, 103, 108 AND 109 GAS OF $3.50.
(2) ASSUMING PRICE CEILING FOR SECTION 102, 103, 108 AND 109 GAS OF $3.00.
(3) ASSUMING PRICE CEILING FOR SECTION 102, 103, 108 AND 109 GAS OF $2.50.
(4) ASSUMING PRICE CEILING FOR SECTION 102, 103, 108 AND 109 GAS OF $2.00.
(5) ASSUMING PRICE CEILING FOR SECTION 102, 103, 108 AND 109 GAS OF $1.50.

TABLE 3

March 2, 1983

AVERAGE COST OF GAS FOR 20 MAJOR PIPELINE COMPANIES

Company	WT Av Cost of Gas Purchased	WT Av Cost of Gas Sold	Surcharge	Gas Cost in Rates(3+4)
Cities Service Gas Company	$ 2.524	$ 2.636	$ 0.4515	$ 3.0875
Colorado Interstate Gas Company	2.8993	3.3945 1/	0.2439	3.6384
Columbia Gas Transmission Corporation	3.927	4.045	0.1314	4.1764
Consolidated Gas Supply Corporation	3.6954	3.7749	0.0931	3.8680
El Paso Natural Gas Company	2.8279	3.1595 2/	0.3031	3.4626
Kansas-Nebraska Natural Gas Company, Inc.	2.065	2.418	<0.0944>	2.3236
Florida Gas Transmission Company	2.7635	2.7867	0.1035	2.8902
Michigan Wisconsin Pipe Line Company	3.0528	3.1929	0.2273	3.4202
Natural Gas Pipeline Company of America	2.5769	2.6482	0.0862	2.7344
Northern Natural Gas Company	2.7141	2.8323	0.0440	2.8763
Northwest Pipeline Corporation	3.3748	3.5753	-0-	3.5753
Panhandle Eastern Pipe Line Company	3.1881	3.2651	0.5525	3.8176
Southern Natural Gas Company	3.127	3.352	0.1027	3.4547
Tennessee Gas Pipeline Company	3.0915	3.1662	0.2676	3.4338
Texas Eastern Transmission Corporation	2.9667	3.0042	<0.3113>	2.6929
Texas Gas Pipe Line Corporation	2.9660	3.0599	0.2118	3.2717
Transcontinental Gas Pipe Line Corporation	3.1244	3.3310	0.1930	3.5240
Transwestern Pipeline Company	3.0810	3.2119	0.3494	3.5613
Trunkline Gas Company	4.0451	4.1705	0.2444	4.4149
United Gas Pipe Line Company	3.4262	3.4550	0.1760	3.6315

1/ Reflects substantial reduction in projected sales

2/ Reflects an estimated line loss of 12% at issue in the PGA case.

TABLE 4

TOTAL UTILITY OPERATING INCOME
PER MCF GAS PURCHASED

PIPELINE	INCOME ($1000)	INCOME (PER MCF)
****************************	********	*******
CITIES SERVICE GAS CO.	46.495	$.11
COLORADO INTERSTATE GAS	56.578	$.16
COLUMBIA GAS TRANS.	113.73	$.13
CONSOLIDATED GAS SUPPLY	75.125	$.14
EL PASO NATURAL GAS	179.23	$.16
FLORIDA GAS TRANS.	33.794	$.17
KANSAS-NEBRASKA NATURAL GAS	12.195	$.13
MICHIGAN-WISCONSIN P.L.	190.88	$.32
NATURAL GAS P.L. CO.	135.95	$.14
NORTHERN NATURAL GAS	147.69	$.23
NORTHWEST P.L.	83.855	$.29
PANHANDLE EASTERN P.L.	47.765	$.07
SOUTHERN NATURAL GAS	84.367	$.16
TENNESSEE GAS P.L.	154.44	$.14
TEXAS EASTERN TRANS.	77.828	$.08
TEXAS GAS TRANS.	53.202	$.08
TRANSCONTINENTAL GAS P.L.	115.69	$.12
TRANSWESTERN P.L.	33.998	$.09
TRUNKLINE GAS	68.395	$.12
UNITED GAS P.L.	121.21	$.15

TABLE 5

TOTAL FUNDS FROM OPERATIONS PER MCF GAS PURCHASED

PIPELINE	FUNDS (* 1000)	FUNDS PER MCF
******************************	*********	*******
CITIES SERVICE GAS CO.	76.095	$.18
COLORADO INTERSTATE GAS	160.11	$.46
COLUMBIA GAS TRANS.	219.54	$.24
CONSOLIDATED GAS SUPPLY	31.011	$.06
EL PASO NATURAL GAS	460.91	$.42
FLORIDA GAS TRANS.	61.473	$.31
KANSAS-NEBRASKA NATURAL GAS	49.569	$.53
MICHIGAN-WISCONSIN P.L.	379.68	$.63
NATURAL GAS P.L. CO.	190.64	$.19
NORTHERN NATURAL GAS	390.34	$.61
NORTHWEST P.L.	135.2	$.47
PANHANDLE EASTERN P.L.	241.2	$.35
SOUTHERN NATURAL GAS	150.68	$.28
TENNESSEE GAS P.L.	329.44	$.29
TEXAS EASTERN TRANS.	253.48	$.27
TEXAS GAS TRANS.	92.818	$.15
TRANSCONTINENTAL GAS P.L.	111	$.11
TRANSWESTERN P.L.	82.862	$.21
TRUNKLINE GAS	127.2	$.22
UNITED GAS P.L.	120.23	$.14

APPENDIX

BACKGROUND PAPER ON THE NATURAL GAS CONSUMER REGULATORY REFORM AMENDMENTS OF 1983: PRELIMINARY ANALYSIS OF SECTION 101, ADDING A NEW SECTION 603 TO THE NGPA.

Under current FERC procedures, pipeline rate increases reflecting increased purchased gas costs are usually put into effect through a purchased gas adjustment (PGA). This has not always been true. Before 1972 pipelines recovered gas costs through ordinary rate cases, just as they recovered other costs. The rapid increase in natural gas prices during the 1970's made it impractical to rely principally on rate cases for this purpose, however. To avoid administrative backlogs from frequent rate filings and severe cash flow problems for the pipelines, the Commission therefore established the PGA mechanism, which allows inclusion of purchased gas costs in pipeline rates separately from other costs.

Under the Commission's PGA rules, a pipeline files a projection of its future purchased gas costs 60 days before the proposed rate increase would go into effect. The projection covers a period running from that effective date to the effective date of the following PGA. The PGA's purpose precludes the full scrutiny of an ordinary rate case. However, revenues collected through PGA increases are subject to challenge in proceedings under Sections 4 and 5 of the Natural Gas Act. If a challenge is successful, or if a pipeline in fact pays less for gas that it had projected in its PGA filing, the excess revenues are refunded to customers through the PGA mechanism.

The Administration's bill would substantially alter the PGA mechanism by adding a new Section 603 to the NGPA. The new section would establish a ceiling, called the allowed rate, on the recovery of purchased gas costs through PGA's. The allowed rate would be based on the pipeline's average purchased gas cost for the month before enactment and would be increased monthly by an amount equal to the national average purchased gas costs for the month before enactment times the inflation since that month. The purchased gas component of a pipeline's rates could be increased through existing PGA procedures so long as that component did not exceed the allowed rate, but increases above that rate could be put into effect only through the special procedure outlined in Section 603(b).

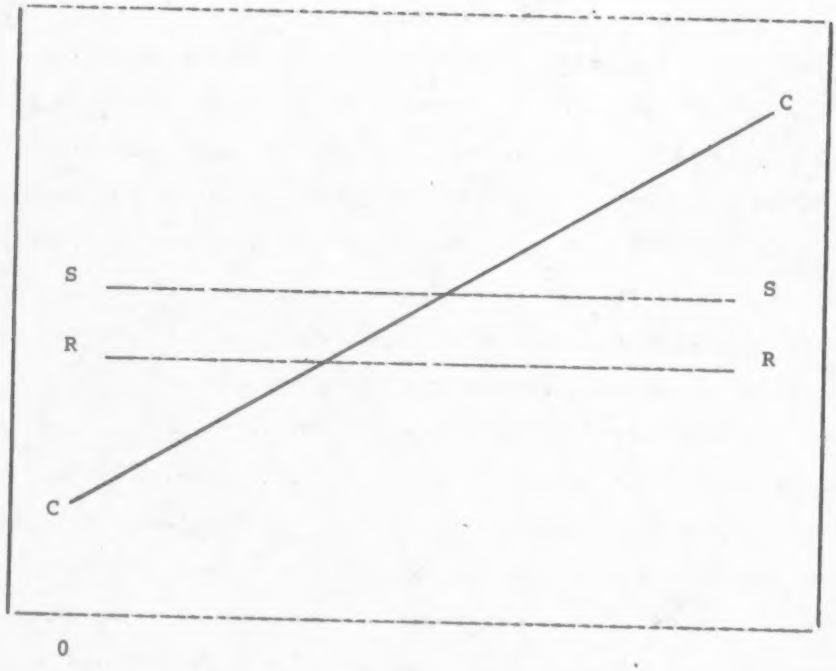
Section 603 thus would require the creation of two distinct new mechanisms. One is a limit on the purchased gas cost that could be recovered through the Commission's existing PGA procedures. It appears that this limit could be practically determined and applied with only minor modifications in the proposed Act's present terms. The second mechanism is a special procedure for the recovery of gas costs in excess of the allowed rate. More substantial changes in the Act's terms may be required in order to make this special rate procedure workable.

A. The Allowed Rate for Purchased Gas Costs

The allowed rate would be based on the pipeline's purchased gas costs for the month preceding enactment and on an inflation adjustment using national average purchased gas costs for that same month. It appears to be intended that the purchased gas costs used for these purposes should be those actually incurred during that month, and not the purchased gas component of the rate then in force. Under FERC procedures, current purchased gas costs generally do not equal the allowed rate established for recovery of those costs. The distinction is illustrated in the following diagram, which represents a pipeline's purchased gas costs and allowed rate over a six-month period.

Line C in the diagram represents the pipeline's actual purchased gas costs over the period. For simplicity it is shown here as a smooth line; in fact, it generally would increase in a series of monthly steps. Line R is the company's rate that is intended to recover those current purchased gas costs. This rate usually would have been established in the pipeline's most recent PGA rather than through a full rate hearing. Most pipelines file PGA's on a six-month cycle and the rate established by the PGA remains unchanged over the six-month period. For the rate to match increasing actual purchased gas costs therefore, it must be above those costs at the beginning of the period and below them at the end.

DIAGRAM 1



In fact, the rate established through the PGA generally proves to be inadequate to cover current purchased gas costs. Under the Commission's rules, pipelines then are entitled to recover the shortfall, with interest, in a subsequent period through a surcharge, represented by Line S in the diagram.

The rates in effect at a given time thus generally include a rate that is intended to cover current purchased gas costs plus a surcharge to cover past shortfalls. Surcharges and total purchased gas costs in effect in March 1983 are set out in Attachment 1 to this memorandum. The surcharge is now as high as $0.55. [1]

The limit established by Section 603 apparently would be based on the pipeline's actual purchased gas costs in the month before enactment (Line C). As illustrated in the diagram, those costs might be either higher or lower than the purchased gas component of the rate then in effect. The limit then would be applied to the pipeline's rates. One question is, does the limit apply to the rates that are intended to recover current purchased gas costs (Line R) or to the surcharge as well (Line S)? To the extent that the shortfall to be covered by the surcharge occurred after enactment, the purpose of the bill would appear to dictate that the limit should apply to the surcharge as well. On the other hand, it can reasonably be argued that a surcharge intended to cover pre-enactment shortfalls should not count against the PGA limit. That interpretation will be adopted here.

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[1] For two of the pipelines listed in Attachment 1 the adjustment is negative. The surcharge is intended to correct for either over- or undercollection of gas costs in prior periods. Under some circumstances, the surcharge therefore may be negative. For instance, the pipeline may have overestimated the cost of its gas supply, perhaps because a new and lower price was negotiated with a producer subsequent to the effective date of a PGA filing, or because the pipeline ultimately took a lower-priced mix of gas from its suppliers than it had projected. A negative surcharge may also result from an underestimation of volumes in the calculation of a previous surcharge, leading to an overcollection in that period. In addition, the surcharge also is used to flow through refunds from producers. As an example, such producer refunds may occur when a well is determined to have been ineligible for the NGPA price category under which the producer had been receiving payments.

A second significant interpretative point is that Section 603 appears to be concerned principally with the means by which rates are established and not with the level of those rates themselves. Thus, rates lawfully put into effect through PGA's before enactment presumably would not become unlawful merely because they exceeded the allowed rate for purchased gas costs following enactment. As a practical matter, therefore, Section 603 would become relevant at the time that the first post-enactment PGA went into effect. 2/

2/ An alternative interpretation is that the act would become effective at the time of the first post-enactment approval of a PGA. On this latter interpretation, PGA's approved before enactment would be allowed to go into effect after enactment without being subject to the limit.

On the above interpretations, it appears that the allowed rate limit is expected to work as follows. Implementation of the allowed rate limit would consist of two parts. The first part consists of determining the limit; the second consists of applying it to proposed pipeline rate increases. It is with respect to determining the limit that the principle difficulties lie, and some modification of the bill's terms appears to be required. The application of the limit after it is determined appears, on the other hand, to be reasonably straightforward. 3/

To permit the Commission to determine the limit, the bill requires each pipeline to report its average cost and volume for purchased gas for the month preceding enactment. This report must be filed by the fifth day following enactment, and the Commission must then determine the limit in time for it to be applied to PGA's going into effect at the beginning of the month following enactment.

This time schedule appears to be unrealistic. First, pipelines generally would not know the purchased gas costs and volumes for the preceding month by the fifth day following enactment. Second, at least some minimal implementing regulations probably would be required in order to make the reporting requirement effective. The first problem could be met either

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3/ The problem of applying the limit has to be distinguished from the problem of dealing with purchased gas costs that cannot be recovered within the limit. The latter problem is not at all straightforward and is discussed in the next section of this memorandum.

by delaying the effective date of the limit or by basing it on purchased gas costs for an earlier month. The second problem would require at least some delay in the effective date. One possible solution to the two problems would be as follows:

(1) The Commission would be required to issue implementing regulations within 30 days after enactment.

(2) Pipelines would be required to file price and volume data within 15 days following issuance of the regulations.

(3) The data filed by pipelines would relate to the month before enactment where possible, but the Commission would be given some flexibility to accept, on a temporary basis, data for an earlier month if data for the month before enactment were not available. To the extent that earlier data were used, an appropriate inflation adjustment would be made. 4/

(4) The limit would become effective 60 days after enactment.

To avoid confusion, however, the following discussion of the application of the limit will be based on the bill's present

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4/ Since pipeline costs have been increasing faster than inflation, pipelines presumably would have a strong incentive to replace the inflation-adjusted earlier data by actual data for the month before enactment as soon as possible.

time schedule. At the time of enactment, each pipeline would have a rate in effect as a result of its most recent PGA. Those rates would not be changed. During a six-month period following enactment, however, new PGA's would go into effect for nearly all pipelines. 5/ The purchased gas component of the new rates could not exceed the sum of (1) the allowed rate, and (2) any surcharge for pre-enactment of shortfalls.

As noted earlier, the allowed rate limit applies to rates, not to the costs justifying the rates. The purchased gas component of the new rates would be based on the projection of gas costs over the six-month cycle. If gas costs were expected to increase over the period, the costs projected for the end of the period would generally be higher than the purchased gas component of the new rate established by a PGA; the undercollection at the end of the period would be balanced by overcollection at the beginning. It thus is quite possible for the purchased gas component of the new rate to be less than the allowed rate even though it is based on purchased gas costs that are projected to exceed the allowed rate by the end of the period.

ILLUSTRATION

Assume that the bill is enacted on July 10, 1983. By July 15, all interstate pipelines would file cost and volume data for their purchases during June. Interregional Pipeline's

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5/ The PGA schedule for the major pipelines is attached. A few pipelines use a one-year PGA cycle.

average purchased gas cost for June is $3.00; the weighted average national purchased gas cost for that month is $3.25.

Interregional's next PGA goes into effect on October 1, 1983. The inflation adjustment for June-October is 2 percent. Interregional's allowed rate for October thus is: .02 x $3.25 = **$0.065**. The purchased gas component of Interregional's rates in its October PGA thus cannot exceed **$0.065** plus any surcharge necessary to make up for pre-enactment under collections. To the extent that the rate needed to recover Interregional's gas costs exceeds **$0.065**, it must be approved through the special procedure described in the next section of this memorandum.

B. The Special Rate Procedure

Some pipelines may be able to pursue reasonable gas purchasing and renegotiation policies without reaching the allowed rate limit. Other pipelines, however, may be affected by the limit in two ways. First, some pipelines may find that their purchased gas costs rise above the limit regardless of any steps they may take. This might be true of a pipeline with a relatively large amount of inexpensive old gas. Such a pipeline's gas costs might be reduced relatively little by the gas cap imposed by Section 301 of the bill. On the other hand, its average gas costs would continue to increase as a result of the application of the NGPA inflation escalator to the price ceilings on its old gas and also as a result of the gradual depletion of that old gas. Second, other pipelines may be able to keep their purchased gas costs below the allowed rate limit but only by following policies that do not serve the long-run interests of their customers. At least two such policies may be available to a pipeline. One is to defer purchases of new reserves. The effect of this policy is to require a more aggressive purchasing policy later, and the bargaining required by more aggressive purchasing is likely to lead to higher gas costs. An alternative policy is to acquire new reserves at an initial low price by promising the producer a large price increase after 1986. Both policies and their consequences can be seen in the behavior of interstate pipelines under federal price controls in the 1970's.

If the allowed rate is not to lead to severe financial difficulties for some pipelines or to irrational gas purchasing and renegotiation practices, the special procedure for recovery of purchased gas costs in excess of the allowed rate must allow for the full and expeditious recovery of costs that meet the substantive standard. In its present form, Section 603(b) does not meet this test.

The section imposes both substantive and procedural limits on recovery of purchased gas costs. The substantive limit is very general: "The Commission shall allow recovery if it determines that the costs sought to be recovered were just, reasonable, and prudently incurred." This standard is more demanding than the fraud and abuse standard now established by NGPA Section 601. The bill's standard is not, however, obviously more stringent than the one previously applied under the Natural Gas Act. 6/ Some modification or clarification of the general standard may be appropriate, but the principal difficulty lies in the procedural limits imposed by the section.

The section appears to impose three procedural limits. First, rates may not be collected subject to refund; they may, in other words, be collected only after a final decision by the Commission. For Section 603(b) itself, this limit is explicitly stated, and the section's evident purpose appears to imply that a pipeline could not avoid the limit by seeking to recover increased purchased gas costs through an ordinary Section 4 rate case. 7/ Section 603(b) presumably is the exclusive procedure where the purchased gas component of a pipeline's rates would exceed the allowed rate.

6/ In Tennessee Gas Pipeline Co., 21 FERC ¶ 61,004 (1982), the Commission stated: "Sections 4 and 5 proceedings [under the Natural Gas Act] have been the traditional forum for testing the prudence of management decisions with system-wide effects." See also Tennessee Gas Pipeline Co., 17 FERC ¶ 16,287 (1981) (prudence to be considered under Section 4).

7/ Under Section 4(e) of the Natural Gas Act, 15 U.S.C. § 717(e), the Commission has the authority to suspend a filed rate for up to five months. At the end of the suspension period, unless the Commission has already determined and prescribed the just and reasonable rate, the filed rate becomes effective, subject to refund, once the just and reasonable rate has been determined. Under present practice, nearly all filed rates are suspended for one day. Thereafter the rates become effective subject to refund.

The second apparent limit is that rates may not be used to recover costs incurred before the rates went into effect. This prohibition on retroactive ratemaking is well-established under the Natural Gas Act. The silence of Section 603(b) on the issue presumably means that the principle governs this Section as well.

Third, rate increases under Section 603(b) apparently can be based only on past costs. This limit appears to be implicit in the section's use of the past tense: the Commission must find that the costs "were just, reasonable, and prudently incurred." This limit means that a pipeline cannot obtain a rate increase based on projected future costs.

The relationship between the last two limits may merit some explanation. Suppose that a pipeline's purchased gas costs increase in June. In July the pipeline files for a rate increase based on the June cost increase, and the rate increase is approved and goes into effect in November. The prohibition against retroactive ratemaking means that the November rates cannot be used to recover the cost increases from June through October; if the rates then in effect were not adequate to recover the pipeline's full purchased gas costs, the shortfall is lost to the pipeline forever. 8/ On the other hand, the

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8/ Rate adjustments pursuant to a Commission-approved PGA clause do not violate the prohibition of retroactive ratemaking. East Tennessee Natural Gas Co. v. FERC, 631 F.2d 794, 800 (D.C. Cir. 1980). Rather, the PGA clause is filed as part of the tariff schedule, and treated as a set formula for calculation of rates. In theory, the PGA rate adjustments should have no impact on the companies net revenues. The revenues collected pursuant to the PGA clause are collected subject to refund at least until a new base tariff is approved. 18 C.F.R. § 154.38(d)(4)(vi)(a).

November rate can be based on the June cost increase. In effect, the June costs are being used in a way analogous to a past test year in ordinary utility rate regulation: the pipeline's cost experience in June is being taken as representative of the costs that it will incur during the period when the rates are in effect.

This combination of procedural limits has two serious adverse consequences. The first is that they make it virtually impossible for a pipeline to recover its full purchased gas costs if those costs cannot be recovered within the allowed rate period. The first two limits mean that the pipeline cannot recover uncompensated cost increases during the period before the rate is approved. The third limit means that the pipeline cannot avoid further undercollection by projecting future cost increases. The result is illustrated in Diagram 2.

In Diagram 2, the pipeline's costs are represented by Line C. The purchased gas component of its rates is represented by the stairstep Line R. At A, the pipeline files for a rate increase based on its purchased gas cost at that time. Its rate filing is represented by the dashed line. The rate actually goes into effect at B. By that time, however, its costs have increased further and it therefore files for a new rate increase, represented by the next dashed line. The cycle thus continues.

The result is a series of rate "stairsteps." Rate increases under the present PGA mechanism take the same form, but there is this fundamental distinction: as illustrated by Diagram 1 earlier in this memorandum, the present PGA mechanism provides for full compensation for purchased gas costs, by basing rates on projected costs and by using a surcharge to correct errors in the projection. Under the procedure apparently contemplated by Section 603(b), however, the rates are at no time adequate to cover a pipeline's purchased gas costs. The area between the cost Line C and the rate Line R represents costs that the company can never recover. Its underrecovery does not stem from an assessment that those costs were unreasonable on imprudent. It is solely a result of Section 603(b)'s procedural limitations. The only question is how large the shortfall will be.

The second adverse consequence of Section 603(b)'s procedural limits is that they are likely to lead to an impossible procedural overload for the Commission. In Diagram 2, it was assumed that a pipeline would wait until one rate increase went into effect before filing for a new one. In order to minimize the shortfall, however, pipelines are in fact likely to make new filings as often as their purchased gas costs show any significant increase. The result is illustrated in Diagram 3. As in Diagram 2, Line C represents the pipeline's purchased gas costs and the heavy

DIAGRAM 2

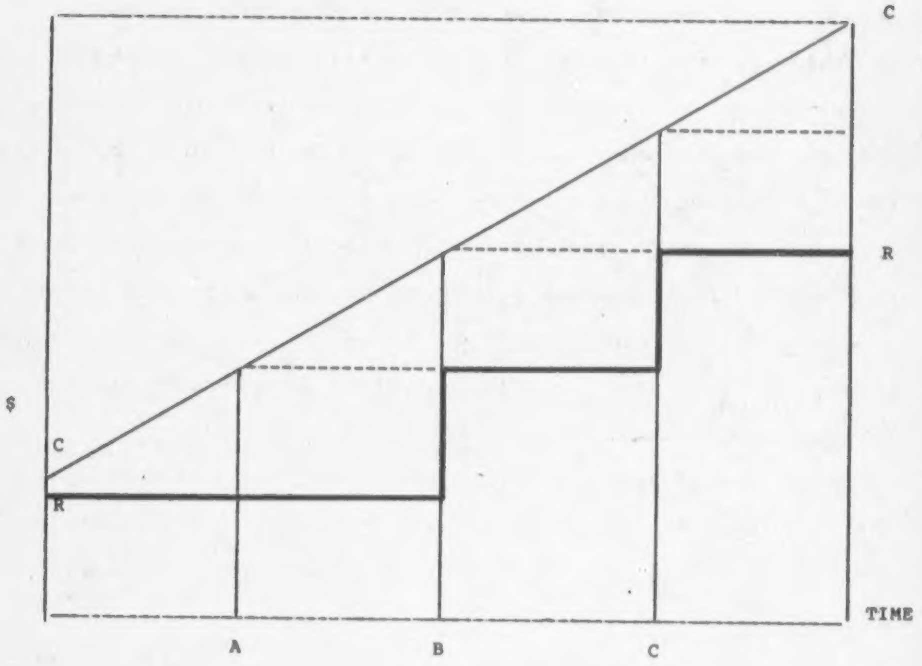
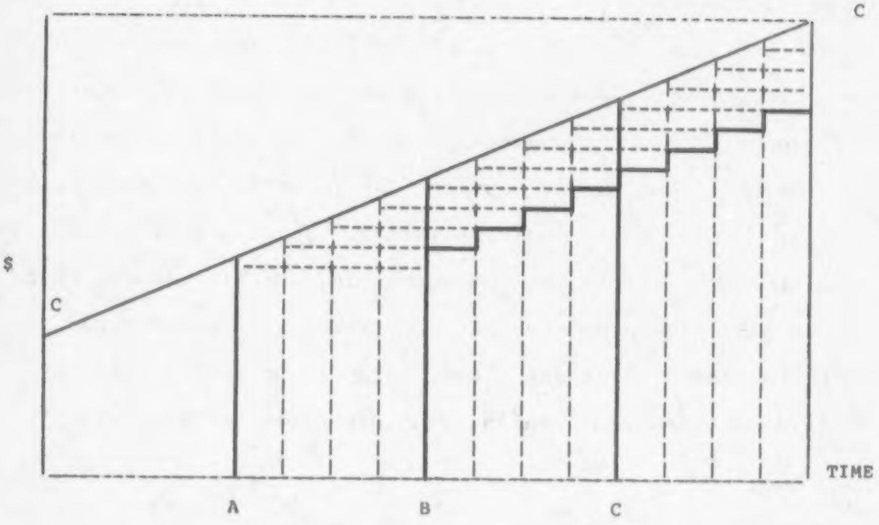


DIAGRAM 3



Line R represents the rates actually in effect. In Diagram 3, however, pipelines file for new rate increases every month. Diagram 3 assumes that the Commission would be able to make a final decision on a new rate filing within four months. On average, therefore, each pipeline has four Section 603(b) rate filings pending at any given time; if the Commission could not decide rate cases under Section 603(b) within four months, the number of rate cases would be larger. There are at present 58 pipelines subject to the PGA mechanism. Section 603(b) thus could easily lead to over 200 concurrent rate cases dealing with purchased gas costs alone, in addition to the ordinary Section 4 rate cases dealing with pipelines' other costs.

Attachment 1

March 2, 1983

AVERAGE COST OF GAS FOR 20 MAJOR PIPELINE COMPANIES

Company	WT Av Cost of Gas Purchased	WT Av Cost of Gas Sold	Surcharge	Gas Cost in Rates(3+4)
Cities Service Gas Company	$ 2.524	$ 2.636	$ 0.4515	$ 3.0875
Colorado Interstate Gas Company	2.8993	3.3945 1/	0.2439	3.6384
Columbia Gas Transmission Corporation	3.927	4.045	0.1314	4.1764
Consolidated Gas Supply Corporation	3.6954	3.7749	0.0931	3.8680
El Paso Natural Gas Company	2.8279	3.1595 2/	0.3031	3.4626
Kansas-Nebraska Natural Gas Company, Inc.	2.065	2.418	<0.0944>	2.3236
Florida Gas Transmission Company	2.7635	2.7867	0.1035	2.8902
Michigan Wisconsin Pipe Line Company	3.0528	3.1929	0.2273	3.4202
Natural Gas Pipeline Company of America	2.5769	2.6482	0.0862	2.7344
Northern Natural Gas Company	2.7141	2.8323	0.0440	2.8763
Northwest Pipeline Corporation	3.3748	3.5753	-0-	3.5753
Panhandle Eastern Pipe Line Company	3.1881	3.2651	0.5525	3.8176
Southern Natural Gas Company	3.127	3.352	0.1027	3.4547
Tennessee Gas Pipeline Company	3.0915	3.1662	0.2676	3.4338
Texas Eastern Transmission Corporation	2.9667	3.0042	<0.3113>	2.6929
Texas Gas Pipe Line Corporation	2.9660	3.0599	0.2118	3.2717
Transcontinental Gas Pipe Line Corporation	3.1244	3.3310	0.1930	3.5240
Transwestern Pipeline Company	3.0810	3.2119	0.3494	3.5613
Trunkline Gas Company	4.0451	4.1705	0.2444	4.4149
United Gas Pipe Line Company	3.4262	3.4550	0.1760	3.6315

1/ Reflects substantial reduction in projected sales

2/ Reflects an estimated line loss of 12% at issue in the PGA case.

Attachment 2

PGA Effective Dates

JANUARY 1, AND JULY 1

Alabama-Tennessee Natural Gas Company
East Tennessee Natural Gas Company
Chattanooga Gas Company, a Division of Jupiter Industries, Inc.
Granite State Gas Transmission, Inc.
Midwestern Gas Transmission Company
Sea Robin Pipeline Company
Southern Natural Gas Company
South Georgia Natural Gas Company
Tennessee Gas Pipeline Company, a Division of Tenneco, Inc.
Tennessee Natural Gas Lines, Inc.
United Gas Pipe Line Company
Distrigas of Massachusetts Corporation
Gas Gathering Corporation

FEBRUARY 1, AND AUGUST 1

Lawrenceburg Gas Transmission Corporation
Mid Louisiana Gas Company
National Fuel Gas Supply Corporation
Texas Eastern Transmission Corporation
Texas Gas Transmission Corporation
Utah Gas Service Company

MARCH 1, AND SEPTEMBER 1

Algonquin Gas Transmission Company
Columbia Gas Transmission Corporation
Consolidated Gas Supply Corporation
Eastern Shore Natural Gas Company
Mississippi River Transmission Corporation
Natural Gas Pipeline Company of America
North Penn Gas Company
Panhandle Eastern Pipe Line Company
Transcontinental Gas Pipe Line Corporation
Trunkline Gas Company

APRIL 1, AND OCTOBER 1

Arkansas Louisiana Gas Company
El Paso Natural Gas Company
Florida Gas Transmission Company
Mountain Fuel Supply Company
Northwest Pipeline Corporation

Oklahoma Natural Gas Gathering Corporation
Pacific Interstate Transmission Company
Raton Natural Gas Company
Southwest Gas Corporation
Transwestern Pipeline Company

APRIL 23, AND OCTOBER 23

Cities Service Gas Company
Commercial Pipeline Company, Inc.

MAY 1, AND NOVEMBER 1

Kentucky-West Virginia Gas Company
McCulloch Interstate Gas Company
Western Gas Interstate Company
Michigan Wisconsin Pipe Line Company
Montana-Dakota Utilities Company
Valley Gas Transmission, Inc.
Great Lakes Gas Transmission Company

OCTOBER 1

Colorado Interstate Gas company
Northern Natural Gas Company (Peoples Division)

NOVEMBER 1

Inter-City Minnesota Pipelines Ltd., Inc.

JUNE 1, AND DECEMBER 1

Louisiana-Nevada Transit Company
Mountain Fuel Resources, Inc.
South Texas Natural Gas Gathering Company
Western Transmission Corporation
Texas Gas Pipe Line Corporation

DECEMBER 1

Kansas-Nebraska Natural Gas Company

DECEMBER 27

Northern Natural Gas Company

Chairman **Butler**. I will be happy to respond at this point to the question that was raised by Senator Metzenbaum.

The **Chairman**. I was going to suggest that you do that at this point, please.

Chairman **Butler**. Thank you, Mr. Chairman. Senator Metzenbaum, the way that Northwest developes a stake in this project is this:

Old gas price controls under the NGPA provide an inventory of gas priced at below market levels against which pipeline purchasers can average higher than market price gas. In so doing, as long as the pipeline's weighted average gas cost does not reach or exceed the level of alternative fuel costs, he is able to continue to buy above-market gas.

For example, in the Trunkline LNG case involving incremental pricing, the decision was made that the project couldn't go forward in Opinion 796 because the Commission initially required incremental pricing. It was this averaging system that was at stake. There was a need for this inventory of cheap old gas to support the payment of the higher than market costs of Algerian gas.

In the case of Northwest, they have spent a great deal of money in the Alaskan gas project. The President's decision that was issued pursuant to ANGTA, the Alaskan Natural Gas Transportation Act which was passed in 1977, states—and it became law, by the way, under the term of the statute—it states that the investment in that project cannot be recovered from the American consumers until that pipeline is completed and operating. That means that Northwest stands to lose a heck of a lot of money if the Alaskan project is not built.

Now the price of its gas may be as high as $20. I don't know whether it would go that high, but that is neither here nor there. That gas is probably going to be priced at an above-market level. It can only be sold to the American consumer if the price can be averaged down by rolling it in with old, relatively low-priced gas. That is where the Northwest stake is.

You will find the same thing with respect to a company like Panhandle or Trunkline, and I am not disparaging or derogating these companies. It is very simple for one to understand their motives once one understands the way in which the statute operates, and that is one of the problems that I think the administration's S. 615 does an effective job of dealing with by permitting the elimination of old gas price controls.

The **Chairman**. Thank you, Mr. Butler, for your testimony. I note that in your prepared statement on the first page you make reference to the powers of FERC to deal with the existing contracts.

Chairman **Butler**. Yes, sir.

The **Chairman**. A good portion of the charges that have been made deal not just with existing contracts but a discretion that has been exercised by the Commission in initial decisions under the terms of NGPA. The price increases within individual gas categories, rapid increases in old gas prices, and several rulemakings underway at the present time that will further increase prices, there are those who say that is not the result of the law so much as it is the discretion or the judgment exercised by the Commission in each of those cases.

Would you care to comment?

Chairman BUTLER. Yes, sir, I would. I have read the prepared testimony of a number of the witnesses who appeared earlier. Let's take first of all the allegation that the Commission allows producers to classify wells in the highest priced category; that is statutorily required by section 101(b)(5) of the statute, rules of general applicability.

As to the question whether the Commission has allowed prices in statutorily prescribed categories to rise to high levels, the answer is the statute prescribes those limits. We implement them except in the two cases I mentioned earlier, that of the tight sands gas and that of the old gas. As far as old gas is concerned, I think Congressman Gephardt in the "Dear Colleague" letter that he sent soliciting cosponsors for his bill in the House recognized specifically that the Commission arguably has the authority under sections 104, 106, and 109 of the Natural Gas Policy Act to increase old gas prices. We do not have the authority to lower those prices, nor can we lower prices under sections 102 and 103 which is really where the problem is right now.

We certainly cannot lower deregulated gas prices under section 107.

The only place the Commission arguably has discretion to lower prices is under section 601(c) of the Natural Gas Policy Act. That provides not that we can directly regulate prices charged under the contract, but the ability of the pipelines to pass through those charges to their customers. The Commission in its analysis of the NGPA which includes an analysis of minutes of meetings held by the conferees decided that our authority under that provision of the statute is extremely limited. Our policy statement in connection with it reflects that.

The consequence is that we are very, very strongly limited in ability to disallow passthrough.

One last thing that I would like to mention, the Commission does have the opportunity indirectly to get gas prices down, but that can only be accomplished over time, and, practically I think, absent the kind of disaster that may occur in the next several months in the gas market. That was reflected in the Tennessee and United orders that the Commission issued in which we said we were going to look at the pipeline's purchasing practices overall, not on a transaction-by-transaction basis, but overall in setting the rates, and to the extent we found that they have moved their prices up to the point where they were pushing load off their system, they would be dealt with accordingly.

The CHAIRMAN. Mr. Butler, in your opinion would the enactment of the administration's bill increase or decrease the average delivered price of gas?

Chairman BUTLER. It would clearly decrease it under today's economic circumstances. My estimates are that it would result in immediate rollback of section 102, 103 prices to a cap level probably that would be around $2.75.

If you take a look at table 1 attached to my testimony you will find a series of numbers pipeline by pipeline. With respect to just those pipelines, the rollback if it goes to the $2.75 cap level would in my judgment push aggregate gas costs down by $1.75 million immediately.

The CHAIRMAN. Would it increase or decrease——

Chairman BUTLER. A billion three quarters dollars—excuse me.

The CHAIRMAN. Would it increase or decrease both short-term gas reserves and supplies?

Chairman BUTLER. I think that it would increase long-term reserves. Gas producers simply are not going to drill for new supplies if they can't market their gas. We have a 1.9- to 2.7-trillion cubic feet supply overhang in the market right now and, under those circumstances, producers are not drilling. You can see that in the drop in rig counts. They are not going to drill under those circumstances. Exploration and development budgets are going to dry up, and we are going to lose our supplies.

On the other hand, if we do something that helps us to preserve the markets and possibly even to expand them by reattracting to the market those who have already switched to alternative fuels, it seems to me that we eliminate some of that surplus and create the incentive for the pipeline producers to continue drilling into the future.

The CHAIRMAN. You note on page 18 of your testimony that the administration's bill has the potential for fundamentally restructuring the way in which the natural gas industry does its business.

Would you please expand on that statement?

Chairman BUTLER. Yes, sir. One of the interesting elements of the natural gas industry which has been recognized over a long period of time is the monopsony control of purchasing that the pipelines are able to exercise. That essentially restricts both buyers and sellers since there is a monopoly at both the selling and buying ends of the gas stream.

The bill attacks the problem from both ends. At the monopsony end it provides the producers with a market, with an ability to require pipelines to carry their gas to purchasers. It also gives the purchasers an alternative to buying from the pipeline, so it attacks both the monopsony and the monopoly elements, and I think arguably substantially moves us in the direction of a truly competitive marketing of gas which I think is ultimately the appropriate policy objective.

The CHAIRMAN. If there is to be a free market in gas, it depends upon the ability of producers and consumers to get together wherever they may be located within the United States.

Chairman BUTLER. Correct.

The CHAIRMAN. It has been suggested that the provisions of the bill are too restrictive or too narrowly drawn to adequately match up transportation facilities with supplies and with consumers because it does not necessarily deal with all of the pipeline links between all potential producers and all potential consumers.

Would you comment on that?

Chairman BUTLER. Yes, sir. It is clear that we are not going to create a perfectly competitive market. There are a variety of reasons for that. The bill's common carrier status is limited. It is limited to the extent that pipelines have available capacity to carry the gas.

It is also limited by the fact that on certain pipeline systems you will run into operating problems like bottlenecks in particular places. However, in my opinion, as an opening step, it achieves a very reasonable balance, and the reason that I say that is this. We cannot simply dictate without creating, I think, terribly serious consequences for our pipeline industry that they are going to switch from the status that they have right now as contract carriers to the status that they would have as common carriers. The reason for that is twofold.

First of all, pipeline financings over time have been structured around their current status, and I think that it could very well be the case that you would upset their situations under existing pipeline debentures.

Second, pipelines have under the Natural Gas Act an obligation to continue to serve their markets, and you have an essential conflict between common carrier status and public utility obligation to maintain service.

The CHAIRMAN. Section 403 of the bill deals with the general contract carrier authorization, and on page 28 of the bill it says the Commission may implement this section by rule or order. That is kind of maybe a rather broad mandate and a broad authority.

In your opinion, could the Commission implement provisions of section 403 which add to new section 317 of the NGPA?

Chairman BUTLER. Mr. Chairman, I believe that the Commission can. As you recall, in my testimony I provided a preliminary staff assessment of both the provisions and of the PGA passthrough sections of the bill. We have not quite got to that point with respect to these carrier provisions, but we are working on it.

My initial assessment is that the Commission would be in a position to develop rules that would fairly implement that section. I think that it may require some technical amendments, but that is going to take us some time.

The CHAIRMAN. Senator Ford?

Senator FORD. Thank you, Mr. Chairman. Will we have the opportunity to come around again?

The CHAIRMAN. Yes, sir.

Senator FORD. Mr. Butler, your thoughts are important to this piece of legislation.

Chairman BUTLER. Thank you, sir.

Senator FORD. I appreciate your forthrightness and your statements and your defense of your position, but your views are desirable. Your views are well known about deregulation of old gas.

Chairman BUTLER. Yes, sir.

Senator FORD. As a matter of fact, some say that you are sitting on a bunch of decisions, and you have already alluded to that this morning, that your agency can make to force Congress to act on deregulation.

You referred to well-financed lawyer in your statement, and I don't know whether that is sour grapes or what, but those on the outside are making more of that on the inside until you get out there.

Now that statement was that there was a backlog of cases that if they would be decided quickly can save American consumers 25 billion. I would like to ask you some questions about some of these cases, and I don't want you to prejudice the outcome of the decisions and I will honor your position knowing your background.

Chairman **Butler**. Yes, sir.

Senator **Ford**. And I hope some of them at least will be decided in favor of the consumer.

When do you intend to act on the administrative law judge's initial decision in the *Columbia* rate case where he found that abusive buying practices favored the pipeline's own subsidiaries?

Chairman **Butler**. Senator Ford, I testified 2 weeks ago before Chairman Sharp's subcommittee in the House on precisely that question, and I made him the commitment and I will make it to you, that the Commission will decide that case as rapidly as we can possibly get it before us. We are committed to doing that.

I am hopeful, although I don't know whether the briefing schedule is going to permit us to do it, I am hopeful that the Commission will have that decision before it in April.

I agree with you. It is a case of the utmost importance and at least at present it is my understanding that the last round of briefing of the law judge's initial decision has not quite been completed. I am advised that March 15 will be the end of that round, so it seems to me that if we really put our shoulders to the wheel we ought to be able to get it out in April.

Senator **Ford**. When did you intend to act on the liquids case?

Chairman **Butler**. That we have already done.

Senator **Ford**. When was that decision made?

Chairman **Butler**. My General Counsel has given me the dates. He knows the dates because those issues have been in litigation. The generic decision was made on January 15. The cases, I think there are 26 of them, are all presently in the process of settlement negotiations. It is hoped that we will have settlements in each of those cases by the middle of May.

Senator **Ford**. Is there an appeals period here?

Chairman **Butler**. I would like to defer to Mr. Moore.

Senator **Ford**. Why don't you light that cigar?

Mr. **Moore**. I didn't want to offend anybody.

Senator **Ford**. You wouldn't offend me.

Mr. **Moore**. Senator, to amplify, the Commission's decision in January that Chairman Butler referred to was a decision that reaffirmed that the Commission would require cost allocation out of gas rates away from gas consumers. That is the general decision. The actual implementation of those decisions are the 26 dockets have all been consolidated for trial.

The trial schedule, I believe, requires that they be settled or tried by the end of May. We are hopeful and we have a number of settlements already, I think, in about seven of those dockets that would actually result in refund to the gas consumers, so I think that those should be before the Commission by the end of May and there will be some relief.

Senator **Ford**. When did you intend to act on AGD's position to rehear the area rate change clause?

Chairman **Butler**. I wasn't, quite frankly, aware that AGD had a petition before us asking us to do that. The area rate issues were settled in Commission orders 23 through 23B, and Charlie, correct me if I am wrong, they were also decided in the fifth circuit.

Mr. **Moore**. It was decided in the *Pennzoil* decision. After that case, Senator, there were several dockets that were set for hearing and AGD is involved in those proceedings. AGD has participated in it and the State of New York; the staff is trying to settle the cases. In fact, we have settled some of those cases. The remaining are set for trial. The Commission got one settlement it didn't think was in the public interest insofar as protecting consumers and sent it back for trial, so those cases are being tried at the trial stage now.

Senator **Ford**. When do you intend to act on the National Association of Regulatory Utility Commission's petition to make all contracts public?

Chairman **Butler**. The Commission does not have that scheduled. I have a hard time telling you just exactly what we would do with it because, I guess, there is potential for a prejudice problem there.

I would make the commitment to you that I will be happy to get that petition up, looked at, and have a Commission make the decision on it.

Senator **Ford**. That would be fine. You made a statement a few moments ago what you thought the average cap price would be of $2.75.

Chairman **Butler**. Yes, sir.

Senator **Ford**. If this piece of legislation was implemented?

Chairman **Butler**. Yes, sir.

Senator **Ford**. What would that price be if only new contracts and not renegotiated contracts are included as the producers have suggested?

Chairman **Butler**. I think that is about where it would be. It takes into account, it takes that into account. If you add the renegotiated contracts to it, I think there is a substantial probability that it will pull prices, the cap price, down.

Senator **Ford**. What I am saying, if it is only a new contract and not renegotiated contracts that are included as the producers suggested, would the price stay higher than your $2.75?

Chairman **Butler**. No, sir.

Senator **Ford**. It doesn't make any difference then?

Chairman **Butler**. No, sir. What I am saying is that my $2.75, and let me suggest to you that that is nothing more than a best guess—as you remember, Secretary Hodel said that the price was under $3 and probably over $2.50, and I just split the difference, to be absolutely honest with you.

Senator **Ford**. You sound like Congress.

Chairman **Butler**. But if I am right about that, that is the market-oriented price. It assumes a market-level negotiation at least on average for all prices. The problem with the renegotiated contracts is that most likely there will be a whole lot more of those. Those prices will probably tend to be somewhat under the market level. As is pointed out in my testimony, the way that that probably could be predicted to work would be that the gas producer says, "Well, if I retrade this deal I am going to get some kind of increase in my price." The pipeline says, "Well, I don't want to get them all the way up to market because I maintain just a little bit of an advantage like that." That would probably be agreeable to a producer to do it that way.

Senator FORD. On page 4, last paragraph, during the year 1985, does the quote "gas cap or price freeze" apply equally to gas purchased by both intra- and interstate pipeline?

Chairman BUTLER. I believe it does, yes, sir.

Senator FORD. Are you sure?

Chairman BUTLER. Actually, what I am doing is looking at your reference.

Senator FORD. Get that Texas counselor to give you some advice.

Chairman BUTLER. What were you reading from, Senator?

Senator FORD. Page 4, last paragraph.

Chairman BUTLER. Of my testimony?

Senator FORD. Yes. That's one advantage to getting it early.

Chairman BUTLER. I got in the office about 4:30 this morning.

Senator FORD. I got mine yesterday.

Chairman BUTLER. I don't see where there is any difference in the way that it impacts interstate and intrastate pipelines, that I can see. If there is a specific way that you think that it would work differently, I would be interested in hearing it.

Senator FORD. During that 1 year now.

Chairman BUTLER. Pardon? Well——

Senator FORD. During 1985.

Chairman BUTLER. What was suggested to me is this: I think I see where you are, where the question is lodged.

Senator FORD. You may see where I am going, too.

Chairman BUTLER. The PGA limitations apply only to the interstate pipelines and not the intrastate pipelines. Arguably, therefore, you wind up with an advantage to the intrastate pipelines as opposed to the interstate pipelines. I believe that is probably right.

Senator FORD. That is exactly what I wanted to hear. I have some other questions, Mr. Chairman. I yield.

The CHAIRMAN. You better quit while you're ahead.

Senator FORD. I'll get into another arena next. Listen, son, if my eyes are open and my mouth is shut, would you send Mrs. Ford a copy? I couldn't even see Butler. That may not be all bad.

Chairman BUTLER. My wife would probably agree with you.

The CHAIRMAN. Senator Hecht?

Senator HECHT. No.

The CHAIRMAN. Senator Metzenbaum?

Senator METZENBAUM. Mr. Butler, I want to be clear that I understand your position. Are you appearing here today as a proponent of the administration's bill?

Chairman BUTLER. I am, except that, as I indicated in my testimony, there are some modifications that I think are necessary.

Senator METZENBAUM. One of them would be to help prices go up faster. You would ask for the FERG to have the right, when a matter was pending before it for special consideration over and above the passthrough, to allow higher rates to go into effect pending the decision; is that correct?

Chairman BUTLER. That is correct.

Senator METZENBAUM. Which would again help the producers or the pipeline, but not the consumers?

Chairman BUTLER. I think it would have the effect of preventing the pipelines from going bankrupt.

Senator METZENBAUM. I have to tell you, Mr. Butler, that my constituents, those who come from consumer States, really look some askance at you—a former attorney for the industry, author of the public and policy platform plank for decontrol, sitting there with the Texas Connection, all three of you from Texas at the time——

Chairman BUTLER. I think that my colleague is from Nebraska.

Mr. MEANS. Close.

Mr. MOORE. I'm from Texas, but I hope you don't hold that against me.

Senator METZENBAUM. What did all of you say? I didn't hear what you said.

Mr. MOORE. I said I'm from Texas, but I hope you don't hold it against me.

Senator METZENBAUM. I don't really hold it against anybody being from Texas. It's all right with me. What I hold against the administration is permitting decisions to be made which affect consumers of this country by three people, two of whom come from Texas, one from Louisiana, and one who I understand formerly was with Pacific Gas and Electric, and I am concerned about the consumer posture.

Now you are sitting there telling me this bill ought to be passed. I find myself in bed with some people that I haven't been in bed with for a long time. I find the utility distribution companies——

The CHAIRMAN. I think I learned something.

Senator METZENBAUM. When John McMillian, Alaska Gas Pipeline, and all the utility distribution companies are saying the same thing as I am, I am starting to look in the mirror and say, Where are you coming from? United Distribution Companies, representing 20 percent of the gas distribution of this country, representing 33 companies, have appeared before this committee and said, "UDC strongly opposes the whole interrelated proposal," they oppose the very heart of the administration's bill for the following reasons: the decontrol of old section 104 gas, coupled with the massive review of contractual arrangements necessary to that end, will cause irreparable public harm of two kinds. One, it will seriously impair the ability of the industry to generate necessary new reserves because the prices which can be paid for future exploration and development will be reduced, and two, it will place undue and unfair economic burdens on consumers in major areas of the Nation. Then Mr. Abram, speaking for Southern California Gas Co., says:

> Unfortunately S. 615 will not accomplish these objectives. The proposal will create chaos and confusion within the industry. The bill would literally cause residential and small business customers billions of dollars. It proposes so-called consumer protection that in fact is only temporary and inconsequential. S. 615 would be pure disaster for the residential gas consumers of America.

And Columbia Gas says—I must say it is probably the first time in my life I ever quoted Columbia Gas: "In our opinion, however, lower prices will not happen in the near term because S. 615 has a number of basic flaws." Columbia opposes deregulation of any gas not planned to be deregulated under the NGPA because this would unnecessarily raise the price to the consumer.

Now under the circumstances, how can you and Mr. Hodel stand before us and tell us that this bill is going to help the consumers of this country? How can you reconcile that position in view of all of the testimony to the opposite effect?

Chairman BUTLER. Well, at the outset, I counseled against being influenced, I suppose, by the special interests who have a stake in the bill. I would simply ask the question, as far as Northwest is concerned: their stake is obvious. As far as distribution companies are concerned, how many of those are also deep gas producers like Laclede and Washington Gas Light?

Senator METZENBAUM. Does that make them all liars? Even if they have a stake in this, does it make them all liars?

Chairman BUTLER. Well, it seems to me that it makes—you want to take a pretty hard look at whether or not their numbers and their analysis bear out their conclusions.

Now, from what I have heard of the conclusions, when I see the analysis, if it bears it out, I will agree with them, but I have yet to see an analysis that bears out the conclusions that you have presented.

Senator METZENBAUM. Give me the other side of the coin. Tell me what analysis you have available to you indicating that this bill will bring down prices to consumers because I have seen the EIA figures which indicated that they actually will go up, and that that was an unpublished report that has not as yet, as far as I know, seen the light of day, but I have seen figures from the Department of Energy indicating that they think that prices will actually go up under this bill.

Chairman BUTLER. Senator, the problem with that study, the problem with the AGA, the various groups who have said it is going to raise prices $40 to $60 million, is fundamental and very easy to find, and that is everybody makes an assumption that doesn't have anything to do with what S. 615 proposes.

That assumption is immediate and total decontrol with no contracts fix. If that were what was proposed I would have to agree that those kinds of consequences follow, but that is not what is proposed. What is proposed will reduce prices by the first PGA filing after the enactment of the bill according to our estimate.

Senator METZENBAUM. It will do what?

Chairman BUTLER. It will reduce prices.

Senator METZENBAUM. It will reduce prices?

Chairman BUTLER. It will reduce prices.

Senator METZENBAUM. Then what about a statement like the following? It is not now possible to predict whether the average cost of gas at the end of 1984 would be lower under the administration's bill than it is today. Would you agree with that statement?

Chairman BUTLER. Yes, sir. It is very simple to explain, too. The price of gas follows the price of oil. To the extent that I cannot predict what oil prices are going to do in 1984 and 1985, I can't predict what gas prices will do in a market-responsive regime.

Senator METZENBAUM. You just said to me that it will reduce prices.

Chairman BUTLER. The day after.

Senator METZENBAUM. The statement I read to you was your own statement, as you know, in which you said you can't predict it, and then you just said to me it will reduce prices.

Now how do you reconcile that? One of your statements has to be wrong. If you can predict it, you can. If you can't, you are saying to us we will do it.

Chairman **Butler**. I cannot make long-term predictions about what oil prices are going to do. Years 1984 and 1985 are long term. If you pass this bill in the next 6 months, I think I can safely predict the prices are going down.

Senator **Metzenbaum**. If we pass this bill in the next 6 months, we are almost into 1984, and you have just said to us that you can't predict whether they are going to go down. Six months from now we will probably be in 1984, 3 months from now, so how—I don't understand you. In other words, it seems to me that you are coming at it from both sides. You are saying, "I can't predict it and yet, Senator, I am telling you that the prices will go down." Now which is right?

Chairman **Butler**. Senator, the problem is, if you take a look at probability, it is usually safer to predict what is going to happen tomorrow than what is going to happen 2 years from now.

Senator **Metzenbaum**. I am not talking about a few years from now. I am talking about 1984. You said prices would go down. You also said you can't predict what will happen.

Chairman **Butler**. I think that I have explained what the difference is. I think I feel relatively safe in predicting what is going to happen tomorrow, but relatively unsafe in predicting what is going to happen in the indefinite future.

Senator **Metzenbaum**. Let me ask you a question, Mr. Butler. We know that you talked about some of the decisions that were made in which you did not vote, but the fact is that you set the price for gas produced from tight sands. You were not involved in that decision, but you have permitted almost anyone to qualify under that decision. I don't think you have turned many cases down. You have held that—the FERC has already added $10 billion to the Nation's gas bill by allowing producers to charge pipelines for gathering compression costs on top of the NGPA ceiling prices—$10 billion.

Now I ask you, you have been on the Commission for 2 years. Can you tell me one decision made during your tenure which has resulted in lower gas-producer prices?

Chairman **Butler**. Tennessee and United will result in lower prices. The NOPR reducing tight sand prices will result in lower prices. I could probably give you a pretty long list of those. This week's decision, for example, in the *City Service* case not to permit throughput conditions in the certificate for City Service pipeline in Wyoming to be shifted to the consumer.

Senator **Metzenbaum**. That isn't a matter of prices coming down. You are talking about a decision to, you didn't permit prices to go up. That's a bit different.

Chairman **Butler**. Senator, you know the problem is the statute prescribes price increases. The statute does, and I can't change the statute. That is for Congress.

Senator **Metzenbaum**. It doesn't prescribe those higher prices in every area in which you permit. It depends upon how you interpret them.

Mr. Chairman, I have overrun my time. I do wish to have a second round.

The **Chairman**. Senator Heinz?

Senator **Heinz**. Thank you, Mr. Chairman. Mr. Butler, how are you going to handle the issue of pipeline accountability after January 1, 1986?

Chairman **Butler**. Well, that is a relatively broad question. It would be handled under the provisions of the S. 615, as passed, and the Natural Gas Act.

Senator **Heinz**. Which would, as I understand it, be basically like 601(c)?

Chairman **Butler**. 601(c) would, so far as I know, not be affected by S. 615, so the consequence—well, let me back off. It would effectively be largely replaced by the PGA passthrough provisions of the new section 603.

As far as the standard is concerned under section 601(c), it would not be modified, but also would not be relevant.

Senator **Heinz**. Now, do you accept the proposition that the pipelines have an inherently—it varies among the situations perhaps, but an inherently inferior market position to producers because they are fixed and represent, in a sense, they are limited in where they can get their sources of supply?

Chairman **Butler**. No, sir. As a matter of fact, as a general proposition I would argue that it is just the reverse. As a general proposition, there are lots and lots of producers out there, but on the other hand, it is not uncommon to find pipelines who are monopsonies, that is, the only buyer in a given production region. As a matter of fact, several of the Commission decisions over the last several years have been designed to eliminate that monopsony advantage that pipelines have.

Senator **Warner**. Could the witness draw the microphone up? I'm afraid a number of us aren't able to hear.

Senator **Heinz**. What about the distribution companies? Do you think that they have a stronger or weaker position than the pipeline companies?

Chairman **Butler**. Well, the distribution companies by definition almost have a much weaker position than the pipelines, and the reason vis-a-vis the producers, that is because the pipelines as a general proposition are intermediaries and purchase, middlemen purchase gas, so there are negotiations.

Senator **Heinz**. So they in a sense are at the mercies of pipelines in the kind of decisions they make, aren't they?

Chairman **Butler**. They can be. They are not necessarily. A lot depends on how the Commission in its policymaking with respect to pipeline rates allocate the market risk.

Senator **Heinz**. I recognize there are differences among distributors, but if a pipeline makes a bad decision and it is virtually the sole source for the particular distribution company, it creates, it can create a genuinely horrendous situation. I think you are aware of that.

Chairman **Butler**. That is correct.

Senator **Heinz**. It can threaten the solvency of the distribution company, threaten the residential consumers with whatever the consequences of bankruptcy are for a local distribution company.

Fortunately I guess we haven't had much experience with that and I don't imagine it would be very good.

Chairman BUTLER. No, sir, it wouldn't. It would not. As a matter of fact, one of the things that is fearful about not getting something done in the relatively near future is that additional loss of market may very well imply not just the bankruptcy of producers and regional banks but also the bankruptcy conceivably of distribution companies and perhaps in some cases pipelines.

Senator HEINZ. You are well aware that many are worried about losing their industrial customers. Because the market clearing process of gas is in western Pennsylvania, most of my State is above that of a number of States in fuel oil.

Chairman BUTLER. Yes, sir.

Senator HEINZ. So that their concern is very well taken, and they have a lot of time to address that. Now let's talk about the kind of problems that pipelines may be able to get themselves into.

Do you know of any instances where there has been evidence of market power, of the seller being used over purchasers of the pipeline? Have you ever seen that happen? Have any people ever found any, ever looked, just as an observor, at producers who might have a large field of gas, a lot of gas, and they have used the power of that gas supply?

Chairman BUTLER. Yes, sir; it is clear that at various times particularly during the period of time that the market was characterized by supply shortages rather than demand limitations such as those we have now.

Senator HEINZ. Have you ever seen any instances where the pipeline might have made a bad decision and decided to purchase from a producer because they had bad information, either because they were given false information or they just made mistakes in their calculations?

Chairman BUTLER. Well, it is awfully hard to ascribe the reasons for the bad decisions. I will certainly concede that I have seen some deals that don't look too good.

Senator HEINZ. Have you ever seen any instances where—I am not asking you to put anyone in jail, but where you have seen collusion or in a sense sweetheart or self-dealing between a producer and a pipeline?

Chairman BUTLER. We have certainly had allegations of that kind of conduct before the Commission.

Senator HEINZ. The other day one of the problems with the area rate clause issued, the Commission decided to interpret the language to include allowing the contract price to rise to the field ceiling price if the producer and the pipeline agreed that is what they wanted to do.

Chairman BUTLER. It was essentially a legal decision. It is a matter of contract language interpretation and where there is an ambiguity is fairly clear under existing contract law for all evidence to determine——

Senator HEINZ. Isn't it true that irrespective of legality or illegality of the ruling, the sum and substance of the rule was that even if the right to increase the price isn't spelled out in the preexisting contract, that as long as the buyer and the seller agree, that that is what they wanted to do, that that would be permitted? Isn't that the sum and substance of it?

Chairman BUTLER. Senator, the sum and substance of my view is that the entire contract is a matter of mutual intent between the parties, and that when you look at any of the contract provisions you have to try and figure out what the parties want to accomplish.

Senator HEINZ. I understand, and I am not trying to make a judgment as to whether your interpretation is right or wrong. I am just saying isn't the sum and substance that where the two parties come in and say well, of course, the intent all along was to allow us to raise the prices, that you have said all right, that's good enough?

By the way, I suppose the decision wasn't made on your watch?

Chairman BUTLER. No, it wasn't.

Senator HEINZ. It was made before you got there.

Chairman BUTLER. However, I must say that in many respects I think that the decision was right.

Senator HEINZ. Just so I understand the decision, am I not stating it fairly accurately?

Chairman BUTLER. That is pretty much the case. The only thing that I would suggest to you is this: In trying to analyze whether the buyer and seller would both automatically come in and present whatever affidavit might be available to prove that the intention was one way or the other, I think you have to take into consideration the interests of the parties.

The pipelines I think are pretty well—they are simply limited.

Senator HEINZ. I just wanted to get my understanding straight. My real concern is you have said that there are instances where clients make bad decisions where shortages occur, where you do get into a situation where the producer can exert a tremendous leverage over the buyer, the pipeline.

For all we know there will be another shortage of natural gas, and of course if history repeats itself as it usually does, and so my question is if we do get into the kind of situation that we went through in 1977 and 1978 where it was a shortage, how do we, assuming we adopt the President's bill, protect the consumers, just customers of the distribution companies and the distribution companies, against what could prove again to be a very serious situation under the administration?

Chairman BUTLER. Well, Senator, the short answer is that I think what the administration's bill does by driving prices back to what our best estimate of the market clearing level, that would be one determined by new contract prices, that you would have an opportunity to eliminate this problem of fuel switching, thereby placing at least limits on, if not reversing, the problem of contracting markets that we have right now. If and as that occurs, I think that what you would find would be that producers would rekindle their exploration and development programs simply because they had markets in which they could sell their gas.

In that sense I think that the administration's bill provides a very direct response to the problem. Now one of the allegations that has been made, and I think that you hear it primarily from high-cost producers, is that—and surprisingly some distribution companies are saying pretty much the same thing—is that very high prices are needed for additional gas production. That is always going to be true, but I doubt seriously whether the price levels on the order that they are arguing are necessary.

Senator HEINZ. My time has expired. That is not really the point I am driving at. My point has to do with the long-run accountability issues here. As I understand the administration's bill, at the end of January 1, 1986 at best there is a new standard that is going to be in effect. There will not be much in the way of consumer protection long term, and we have just established the pipeline has been making a mistake. We have established that certain market conditions can arise where the pipelines are at a real disadvantage, and the consequences of that can be extremely grave downstream.

Now my time has expired, but I hope I will have a chance to return to this subject because I think that there is a real issue of what the responsibility is of you and us having standards to deal with those kind of situations down past January 1, 1986.

Chairman BUTLER. I apologize if I was too obtuse a moment ago to see the direction in which you were headed, and I do now. I will be more than happy to answer that question now or when——

The CHAIRMAN. Go right ahead. You might as well get it now while it is fresh in your mind.

Senator HEINZ. Thank you, Mr. Chairman. I appreciate that.

Chairman BUTLER. The references to the—as I understand it, is to the fact that PGA passthrough limitations expire in 1986, and therefore the question is what is the standard to be applied to the pipeline's ability to pass through its purchased gas costs.

I think the feeling is that it is likely if you rationalize the pricing regime, that not much in the way of those kind of abuses will be left to occur, and the reason for that is relatively simple. Many of the pipelines made bad decisions at least in hindsight. Whether they were when they were made is another question, but at least in hindsight bad decisions were made because the pipelines had this inventory of old gas that they could use basically as a system of price supports.

Now the limitations on their ability to do that depended much on the movement of oil prices. As oil prices have declined, they have found themselves in deep trouble. I think the feeling is that a more market-responsive pricing regime will eliminate the kind of behavioral patterns that occurred under the Natural Gas Policy Act.

Now the Commission retains a fairly broad authority under the Natural Gas Act to disallow costs of the Commission or costs incurred by the pipelines or otherwise to adjust the rates if they make ill-considered decisions.

Senator HEINZ. Now yesterday, if I may—I heard what he said but there is a real misunderstanding if we allow that to stay on the record.

The CHAIRMAN. You will have a chance to take it out of the record later.

Senator HEINZ. We should have really returned to it I think.

The CHAIRMAN. Senator Melcher?

Senator MELCHER. Mr. Butler, the fact that you are now seeking to modify, through the administration bill, what is a very complicated act, seems to be one of the arguments for modifying.

I wonder if this proposal by the administration isn't also very complicated? You recommend the Act be adopted with some modification. On page 5 of your testimony you also say that the gas cap in the proposal would be good for consumers.

Do you think that the present law insulates producer prices from the rigors of the marketplace? And then you say there are two remedies available and the best one, you say, would be for producers and pipelines to negotiate new prices and you indicate that that has not occurred, so that legislative intervention is required.

Can you describe the mechanism in this bill or rather the simple procedure, easily understood, easily enforced?

Chairman BUTLER. No, sir, I would not.

Senator MELCHER. Is there no way of having such a procedure?

Chairman BUTLER. I really wish that I could answer your question yes, but I'm afraid I can't.

Another line of testimony that I think sort of sums it up as well as it can be is that S. 615 mirrors the complexity of the problem.

Senator MELCHER. Well then, the alternatives you say that are available include, first of all I guess the statutory market-out cost?

Chairman BUTLER. Yes, sir.

Senator MELCHER. Is that simple and easily enforced?

Chairman BUTLER. That would probably be the simplest and most easily enforced option available. The problem is that if it were to be permitted immediately in a market that is as uncertain as the one that we have right now, it is very hard to predict what the consequences would be. The cure could be worse than the disease.

Senator MELCHER. Then, the second one that you say is available would be impose statutory limit on the operation of price escalator clauses.

What do you mean, that it can't be a fixed dollar limit but rather a limit designed to approximate the market value of natural gas? Isn't that on the basis of dollars?

Chairman BUTLER. Yes, sir. I think what it is intended to reflect is this, is that one thing that we have definitely learned is that our ability to set prices ourselves is extremely limited. We typically set prices either too high or too low and that results either in shortages like we have had in the past. We had a lot of experience with that with the wage and price guidelines, or alternatively right now as is the case the price is set too high and we wind up losing markets and people get hurt that way.

The suggestion made here is that a dollar limit would be appropriate but it should be one that moves in response to the market and avoids human errors implicit in trying to simply fix a price at some level.

Senator MELCHER. In other words, some flexibility would be provided in the range?

Chairman BUTLER. Yes, sir.

Senator MELCHER. The dollar range or price range, is that easily enforcible and simple?

Chairman BUTLER. No, I don't think it is particularly. I don't think it would be terribly easy, but I have talked to the people at the Energy Information Administration about their ability to collect the data to help us establish that number on an on-going basis.

It may be technical amendments to the precise proposal we have in front of us are necessary, but I think the proposal can be implemented. It will not be precise.

Senator **Melcher**. Would gas from Canada be affected?

Chairman **Butler**. Yes, sir. I think that gas from Canada would be affected. It would be affected indirectly, though. It would be not included in the cap. I can make an argument to you that it should be included in the cap.

Senator **Melcher**. Why would it be affected indirectly?

Chairman **Butler**. What happens is you take, the approach in this bill suggests you eliminate that system of implied price supports that I talked about earlier, that old gas regime against which higher market prices can be arranged. If that goes, pipelines simply cannot afford to pay $4.94 for Canadian gas.

I have advised the Canadians of that on two separate occasions in formal speeches and on numerous other occasions in informal contacts with members of their government.

I think one of the substantial advantages of the bill is that it places the Canadians, and I think they acknowledge this, in the position where they have no choice but to lower their price.

Senator **Melcher**. It wouldn't be subjected to this, the renegotiation provision?

Chairman **Butler**. No, sir, it would not. I am talking about Canadian governmental decisions. I am talking about indirect impact rather than direct contract impact.

Senator **Melcher**. Well, why isn't that indirect effect available right now?

Chairman **Butler**. I think that it is.

Senator **Melcher**. Under present law.

Chairman **Butler**. What is happening under present law, markets are being lost. The cushion has in effect been dissipated by the fact that section 102 and 103 prices are currently probably above market. The result is the advantage that they formerly had, what was in effect a transfer of rent from old gas producers to Canadian producers, no longer works. Since the system is broken, they are in effect forced in the direction of moving prices downward or losing their markets.

Senator **Melcher**. It seems like about half, or close to half, of the gas that is purchased by Montana Power in Montana is Canadian gas. I believe it is $4.94.

Chairman **Butler**. Yes.

Senator **Melcher**. At the border.

Chairman **Butler**. Yes, sir.

Senator **Melcher**. And gas produced in Montana doesn't have a price like that at all, so if this mechanism is available now under current law, why hasn't there been some restriction or some imposition by the Canadians for the prices?

Chairman **Butler**. I think that, to be absolutely honest with you, that it has just been for whatever reason—it probably is political I would guess, probably related to the nature of the Canadian political climate. They felt that they could not respond. The prices are governmentally established.

Senator **Melcher**. There is no way that Montana Power under current law could break the contract for that gas?

Chairman **Butler**. Well, you have to accept this as hearsay, but I am advised a number of pipelines have gone to Canadian suppliers and told them I'm sorry, I can't take gas at your price and I can't take the volumes I am obligated to take under my take or pay provisions, so maybe we have a court fight.

Senator **Melcher**. Is there anything in the proposal that would change that, in the proposed bill?

Chairman **Butler**. There is nothing that would change it directly. There is nothing in the bill that provides for—what you are searching for is a market-out of Canadian contracts. It is not contained in here. I am not sure if there is a way we could make that work, quite frankly.

Senator **Melcher**. There is a situation where domestically produced gas in Montana available at lower prices cannot be substituted for higher priced, dramatically higher priced Canadian gas and that would not be solved by this bill?

Chairman **Butler**. I think that that is probably a fair assessment, and I wish I could tell you otherwise, but I think that I would have to concede Montana Power and Light is probably very much in the same position as a lot of other pipelines or buyers who have contracts with Canadian suppliers.

Senator **Melcher**. In other words, under existing law the situation where the marketplace, where the market is lower on the domestically produced gas than the imported gas is not correct?

Chairman **Butler**. Yes, sir.

Senator **Melcher**. Under the proposed new bill the same is true? It would not be correct?

Chairman **Butler**. Senator, I think what the new bill does it very strongly drives the Canadians in the direction of making their own decisions to lower their own prices. That I see is the advantage to it.

The reason that it does that is because it eliminates or would eliminate over time controls on old gas which basically price supports the very high Canadian border price.

Senator **Melcher**. I think the old gas that is already committed in existing contracts wouldn't have a nickel's worth of effect on Montana Power's present contracts with Canada, and so the new proposal doesn't seem to be of any relief to the producers or to the consumers that are stuck with Montana Power's contracts for Canadian gas. If that doesn't change, there is no reduction.

Chairman **Butler**. I concede, Senator, it does not have that direct effect, but I do believe that indirectly by eliminating the price supports implicit in all gas price controls, that indirectly it does provide some relief by strongly driving the Canadians to lower the prices in order to preserve the U.S. market.

Senator **Melcher**. The current law is indirect. As far as we are concerned, our consumers in Montana and our producers are concerned, it seems to me that they are not asking us to provide a new law, but to modify the old law. That still perpetuates the indirect approach which hasn't been of any value to us at all.

Thank you very much.

The **Chairman**. I might just interject that I believe the evidence we have, Montana Power's contract for Canadian supply is not a take or pay contract. All they have to do is stop taking it.

Senator MELCHER. Well, quite frankly, Mr. Chairman, that opportunity hasn't appeared to be available either to Montana Power, to the consumers in Montana that are supplied by Montana Power, to the State authorities in Montana, nor as is evidenced by Mr. Butler's testimony, under the present law, to FERC, or again according to Mr. Butler's testimony, to any adoption of the proposed bill.

Chairman BUTLER. Senator, may I ask you a question?

Senator MELCHER. Yes.

Chairman BUTLER. Is the reason for that statement that Montana consumers do not have supplies available to them from other sources sufficient to make up what they would lose by exercising that contract capability?

Senator MELCHER. We don't really know, Mr. Butler, because the market price for new gas in the marketplace is so low that this isn't being developed. The shallow gas that is available in north central Montana simply is pretty much at a standstill. Not that the gas isn't there, not that the number of wells that are drilled doesn't bring in a high percentage of producers, but the small amount--and when you can't have enough drilling, that is pretty sure drilling, to bring in a large enough volume to completely replace, we can't get a portion of the Canadian high-priced gas offset by a small portion of the or enough of a portion of the newly produced gas at a low cheaper price to find out how much is there.

The CHAIRMAN. Senator Warner?

Senator WARNER. Thank you, Mr. Chairman. Mr. Chairman, what is your opinion with respect to the allegation that the proposed deregulation by the administration of the old gas would be a windfall to a number of the major oil companies?

Chairman BUTLER. Senator, it is clearly the case that the most substantial beneficiaries of old gas price decontrol would be the major oil companies. It is a rough guess, but it is probably accurate to say that about twenty of the largest producers own probably about 70 percent of the old gas. The consequence is they clearly stand to make money through increases in old gas prices.

As to whether or not that is properly characterized as a windfall, frankly I don't have much of an answer for you.

Senator WARNER. Are you of the opinion that your organization is doing everything it can within the present framework of the law to bring down the price of gas?

Chairman BUTLER. I have testified to that effect before the House Subcommittee on Energy and Fossil Fuels and feel perfectly comfortable in reiterating that today.

Senator WARNER. Thank you, Mr. Chairman.

Chairman BUTLER. In the framework of the statute, we have done everything we can.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman. Mr. Butler, in your testimony you have said that if we had decontrol, gas prices would immediately fall in this economic climate.

Are you referring to the national average price?

Chairman BUTLER. Yes, sir, I am.

Senator BRADLEY. Can you demonstrate that using your table 1 at the back?

Chairman BUTLER. Yes, sir.

Senator **Bradley**. Would you let's say choose a high-cost pipeline? Take Transco. Would you show me how that works?

Chairman **Butler**. Let me look through and find the right table. On Transco, the price decrease, what we have here in the table 1 assumes certain price ceilings that would be the cap, and the question then is as compared to their current average gas costs, what would the total reduction be if the gas cap——

Senator **Bradley**. I can't hear.

Chairman **Butler**. If the gas cap is applied to the average gas cost, the question is—depending on your assumption—what would the total reduction be?

Let's take Transco, for example. The reduction in payments for new gas at the $3.50 assumption which I think is far too high, but to be realistic——

Senator **Bradley**. Where do we see the $3.50?

Chairman **Butler**. It is up at the top. You see assumed ceilings here. That means the assumed cap.

Senator **Bradley**. OK.

Chairman **Butler**. Now at $3.50 there is virtually no effect at all on the Transco system. The reduction would be a total of by $8,000. However, as you can see, largely because of the volumes, as the price declines, the amount of reductions on the system goes up dramatically, so that if we drop to $3, the reductions on the system would rise to $158 million. At $2.50, they would rise to $391 million.

My assumption is that the price of the cap would probably be something on the order of $2.75, probably would fall about between the two, so you could probably take an average of those two numbers, 158, 391, get some kind of an idea about what you might expect.

Senator **Bradley**. Well, why are some of these pipelines high cost volumes?

Chairman **Butler**. It depends entirely on the mix of gas that the pipeline has under contract. Some pipelines have a lot of cheap regulated gas. Others have an awful lot of relatively high-priced gas.

Senator **Bradley**. What do you think would be the effect on residential users if we decontrolled and there were these effects, the $3 level and $2.50 level?

Chairman **Butler**. Well, what I think that you could do would simply be to take the column of numbers under $3 or under $2.50 and aggregate those, and you would have at least a reduction on the order that is suggested here.

One thing that I would suggest is that this list of pipelines is not exhaustive so the actual reductions would be higher. By how much I couldn't tell you.

What I did last night on the basis of my 275 assumption was to add the column of figures under $3 and add the column of figures under $2.50 and take, and I took the simple average of those and that indicated to me that the aggregate impact if I am correct in my guesstimate, the $2.75 is about where the cap would fall, is that the aggregate impact on these pipeline customers would be a reduction of about $1.78 billion.

Senator **Bradley**. $1.7 billion; how do you get $1.7 billion?

Chairman **Butler**. $1.78 billion. In addition to the number being somewhat understated because the list of pipelines is limited, that also does not take account of the fact that there will be reductions due to the 70 percent limitations on take or pay. That would also tend to enlarge the number or amount of refunds to consumers.

Senator **Bradley**. What assumption do you use to get to the $275 cap price?

Chairman **Butler**. Basically——

Senator **Bradley**. What assumptions do you make about level of imports, State regulation, various other things?

Chairman **Butler**. Well, what I have done is to begin with a relatively, somewhat simplified economic model that looks at the nature, first of all, the nature of the gas market, trying to predict what the marginal use of gas is. That is clearly boiler fuel.

Once having done that, you look to the alternatives. First of all, the question whether or not there is significant installed dual fuel capability—I think the answer to that question rather clearly is yes.

Then what you look to is the question what alternative fuel is available to those boiler fuel users? In general it seems to be some grade of No. 6 fuel oil.

Once having done this, you look at the delivered cost in the various markets and back out an assumed cost for transportation and distribution and what that gives you is a Btu equivalent at the wellhead, and that on average should run I think probably in the neighborhood of 275.

Senator **Bradley**. You will be followed today before the committee by the Commissioner of Energy from New Jersey who estimates that the impact of this decontrol on New Jersey would be a 20-percent increase in price.

Now if you are presently at—about what is the average price now would you say?

Chairman **Butler**. The average price at the wellhead?

Senator **Bradley**. Yes.

Chairman **Butler**. The average price at the wellhead, probably on the order of $2.50; actually it has got to be higher than that.

Senator **Bradley**. So if you——

Chairman **Butler**. Excuse me. It is much closer to $3. I was trying to remember the last set of numbers.

Senator **Bradley**. If you had a 20-percent increase, that would be a rather sizable increase.

Chairman **Butler**. Yes, sir, it would.

Senator **Bradley**. You say that won't happen?

Chairman **Butler**. I do not see how it can possibly happen.

Senator **Bradley**. Why?

Chairman **Butler**. The reason is that for every pipeline there is no automatic increase in prices, only an automatic decrease because the cap is applicable to all categories of gas except section 107 gas which is frozen at the current levels.

I think that it is clearly the case that section 102 gas which makes up a sizable proportion of the gas available for markets and section 103 gas probably are above market clearing levels. That means those prices of necessity will be rolled back, so on average for every pipeline at the outset there should be a reduction in price.

Now over time as gas contracts are renegotiated those prices will probably move somewhere within the range of the ceiling established by the section 603 PGA limitation.

Senator BRADLEY. I was just given something. EIA says the average price in 1982 is $2.53, so it is not $3. My time is up. I would like to have you comment on one other statement that is in the Commissioner's testimony. I think this bears on something you said earlier. I would like to read it and then get your response to it.

> A market based on price competition with competing fuels such as residual oil in the major industrial natural gas consuming States does little to help minor consuming States at the end of the pipeline. In 1981, the twenty-four States primarily in the northern tier where industrial natural gas prices were within 80 percent of the residual oil prices accounted for less than 10 percent of total natural gas sales in the United States. If 20 percent of this industrial market is lost to fuel switching, producers lose only 2 percent of their load. It is, therefore, unlikely that the prospect of lost markets in these States will influence the price of natural gas at the wellhead.

Do you agree with that or disagree?

Chairman BUTLER. Well, I disagree with it, but I have to be perfectly candid with you. I don't know what the source of those assumptions are so it is somewhat difficult for me just to simply say no, he is wrong. I won't do that without understanding what his numbers are and what they actually mean.

Senator BRADLEY. Tell me how he might be right.

Chairman BUTLER. It is much more probable that he is wrong, and I would say that for this reason. Right now in the natural gas market there is a surplus deliverability of about 1.9 to 2.7 trillion cubic feet of gas. If we are correct in our assumptions about what may very well happen in connection with fuel switching, over the next 6 months that would add about a trillion and a half cubic feet to 2 trillion cubic feet of lost sales to that number.

Under those circumstances, there is an enormous, overwhelming incentive on the part of the producers to take whatever actions are necessary to regain the market. If that means lowering their prices, I think that is what they will do.

Senator BRADLEY. Thank you very much. My time is up. May I ask you one more question? Yes or no answer—would you oppose a program run by HHS to provide financial assistance to low-income people affected by the higher prices from decontrol?

Chairman BUTLER. No.

Senator BRADLEY. Thank you.

The CHAIRMAN. Let me inquire of the members of the committee, we have concluded one round of the questioning and I would point to the fact that we have been here since 9:30, a little less than 2 hours, and we have 19 more witnesses. Is there a willingness on the part of the members to forego a second round or to limit the second round?

Senator FORD. Mr. Chairman, I have several questions but if the other members will forego, I will forego.

Senator WARNER. I join.

Senator BRADLEY. Mr. Chairman, I would have a number of questions but if everyone else will forego, I will forego.

Senator HEINZ. Yes.

Senator **Ford**. We'll just name the horse "Forego!"

The **Chairman**. I think this horse is running! I thank all the members for their restraint and I thank you, Mr. Chairman, for your willingness.

There will be questions submitted in writing. If those questions are presented to us by close of business on Monday we will submit them to you.

Senator **Ford**. Could it be Tuesday? Today is Saturday.

The **Chairman**. I know. I thought Monday was enough.

Senator **Ford**. I am not sure that I can get out of church in time to write these up tomorrow.

The **Chairman**. The close of business on Tuesday, and we would hope for a prompt response to those questions and the answers can be included in the hearing record.

Chairman **Butler**. We will turn those around immediately, Mr. Chairman.

The **Chairman**. Thank you very, very much. The next witness is the National Association of Regulatory Utility Commissioners—Ms. Laura Murrel, Public Service Commission, Commonwealth of Kentucky; Mr. Brian Lederer, National Association of State Utility Consumer Advocates; Frank Simoneaux, Louisiana Department of Natural Resources; Mr. Leonard Coleman, commissioner, New Jersey Department of Energy; and Mr. Philip R. O'Connor, chairman of the Illinois Commerce Department.

Senator **Bradley**. Mr. Chairman?

The **Chairman**. Senator Bradley.

Senator **Bradley**. Mr. Chairman, I would like to welcome to the committee the commissioner of energy, New Jersey, Leonard Coleman, who I think is doing a fine job in the State. I hope that the committee will listen very carefully to his analysis because I think it is one that we need to hear as to how this action might indeed affect some States at the end of the line.

He knows the issue very well, and I hope the committee will give him careful attention, and I welcome him to this committee.

Mr. **Coleman**. Thank you.

Senator **Ford**. Mr. Chairman?

The **Chairman**. Senator Ford.

Senator **Ford**. Mr. Chairman, the northeast end of the capitol building in Frankfort, Ky., is where the Governor normally enters the building and walks down the marble hall to his office.

In that hall there was a very small and inadequate office attached to the attorney general's office. As the Governor would walk back and forth along those marble halls he would see a young lady laboring early and late to accomplish a job. I think the young lady representing the Regulatory Utility Commission today should have some accolades because the consumer legislation that was passed in 1972 in Kentucky came out of the small, inadequate space that this lady occupied.

I personally believe along with others that the legislation that was passed during that period of time which has her imprint is adequate for years to come. I now find her as chairman of the Public Service Commission of Kentucky. I compliment her on her progress, and I compliment her on her position, and I am delighted to see that she is here today and look forward to her testimony, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Ford. Let me say to all witnesses not just on this panel, but those others who will be on the later panels as well, I think we all recognize the constraints of time and we will conduct the hearing today in the same manner we have the previous 3 days, that is, the prepared statements that have been presented to us will be made a part of the record in full. Each of the witnesses will be asked to confine their summary of those statements and extemporaneous remarks not to exceed 5 minutes so that we can get tc the questions and hopefully get done some time before the end of this day.

With that, we will call on—is Mr. Lederer present?

Mr. RODGERS. He is here, Senator. He was out in the hall a few moments ago.

The CHAIRMAN. Maybe somebody will go out in the hall and mention to Mr. Lederer that he is going to be on here pretty quick. If he wants to be heard, he had better be here.

With that, Ms. Murrell, with the kind of glowing comments that you heard from the Senator from Kentucky, you are more than welcome here. We look forward to hearing from you.

Ms. MURRELL. I was going to mention that we do have tremendous consumer fraud legislation in Kentucky passed by Governor Ford, now Senator Ford.

STATEMENT OF LAURA L. MURRELL, CHAIRMAN, KENTUCKY PUBLIC SERVICE COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, ACCOMPANIED BY PAUL RODGERS, GENERAL COUNSEL AND ADMINISTRATIVE DIRECTOR

Ms. MURRELL. My name is Laura Murrell. I am chairman of the Kentucky Public Service Commission. I am testifying today on behalf of NARUC, the National Association of Regulatory Utility Commissioners.

I am accompanied by Paul Rodgers, our general counsel. I have prepared testimony which has been filed and I would like to summarize it.

As a State regulator, one of the most frustrating things is to get the blame for higher natural gas prices when there is little or nothing that we can do.

I have appeared before my State legislature. I have talked to consumers in my State and I have told them that basically there is only two things I can do. One is to have our State intervene before Chairman Butler and the FERC, and the second is to come to Congress.

We have done the first, and today we are here on behalf of NARUC, the Kentucky Public Service Commission, and Kentucky consumers to do the second.

Attached to my prepared testimony is a bill that has been prepared by a special task force of the NARUC Subcommittee on Gas. That bill was approved by the NARUC Committee on Gas this Wednesday, and by the NARUC executive committee this Thursday. This bill, which represents a consensus of many commissioners from very different States, producing States and consuming States, and with various political philosophies, I think covering the gamut, is a consensus of things that we believe need to be done and on which there is apparent agreement.

Basically our bill would increase pipeline accountability by defining abuse under section 601 of NGPA to include imprudence and lack of marketability of gas. It would also fix certain of the more onerous contract provisions that pipelines entered into shortly after the NGPA was passed. We believe these are the provisions that are hurting consumers so badly today.

It would eliminate indefinite price escalator clauses, back down take or pay clauses to 50 percent in existing contracts with provision that more expensive and affiliate gas must be backed down first and would provide a unilateral pipeline market-out on existing contracts.

It also requires the filing of contracts with FERC, something that Senator Ford mentioned earlier which NARUC has requested from FERC a long time ago and would repeal incremental pricing.

In addition, it provides for study by FERC and State commissions of more competitive marketing of natural gas. These are not substantive provisions but are provisions for study.

NARUC's official position taken in its 1981 convention is opposed to accelerating decontrol. I think it is fair to say that there is not a consensus for either accelerated decontrol or for extension of controls beyond that provided in the NGPA or for a price freeze among the NARUC commissioners. That is not to say that individual commissioners might not support more far-reaching provisions in various directions than those set out in this bill. This bill represents points on which there is a consensus and on which we feel action is imperative.

Thank you for this opportunity, and I will be glad to attempt to answer any questions.

[The prepared statement of Ms. Murrell follows:]

UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES

STATEMENT OF THE

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

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ON

S. 60, S. 239, S. 291. S. 293, S. 615 and S. 689,

BILLS TO AMEND

THE NATURAL GAS POLICY ACT OF 1978

MARCH 12, 1983

Mr. Chairman and Distinguished Members of the Committee:

I. Introduction

Good morning. My name is Laura L. Murrell, I am Chairman of the Kentucky Public Service Commission, a position I have held since 1982. I am testifying today on behalf of the National Association of Regulatory Utility Commissioners, commonly referred to as the NARUC. Accompanying me today are Paul Rodgers, NARUC Administrative Director and General Counsel; Rita A. Barmann, NARUC Director of Congressional Relations; and Linda L. Kent, NARUC Assistant Director of Congressional Relations.

The NARUC is a quasi-governmental, nonprofit organization founded in 1889. Within our membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands which are engaged in the regulation of utilities and carriers. Our chief objective is to serve the public interest by seeking to improve the quality and effectiveness of government regulation in America.

The members of the NARUC appreciate this opportunity you have afforded me today to make known their views on pending legislation to amend the Natural Gas Policy Act of 1978 (NGPA). As you know, all but one of the State public utility commissions,[1/] or State PUCs, are charged with the responsibility for regulating retail natural gas sales to residential and commercial ratepayers. The question of future Federal natural gas pricing policy is of vital concern to State regulators, since the major cost components

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[1/] The State of Nebraska does not regulate electric or gas utilities, all of which are owned or regulated by public power districts and municipal governments within its borders.

of retail gas rates--i.e., wellhead prices charged by producers and wholesale or "city-gate" rates charged by transmission companies--are controlled only at the Federal level.

Our concerns are heightened by the fact that today's prevailing prices for natural gas continue to increase even as demand is dropping and gas supplies are growing more abundant. In recent testimony before a House subcommittee, Federal Energy Regulatory Commission (FERC) Chairman C.M. "Mike" Butler III described an informal survey of gas distribution companies undertaken by FERC staff. This survey revealed that significant fuel-switching is occurring around the country as a result of gas prices which exceed market-clearing levels.[2/]

State regulators can readily attest to the pervasiveness of this market loss problem. From our perspective as the officials whose obligation it is to maintain adequate revenues for the nation's gas utilities, we can also verify the existence of the very real dilemma which this problem creates: the only way to assure recovery of the utility's fixed plant costs when industrial markets shrink is to raise prices for its captive customers--the residential and commercial ratepayers--even more.

Most assuredly, the smooth transition to a deregulated gas market which the NGPA's authors intended the law to provide is not occurring. Demand-sensitive pricing of natural gas remains largely an unrealized dream. In our view, as Congress begins the complicated task of rethinking Federal gas policy, the central

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[2/] Statement of C.M. Butler III, Chairman of the FERC, before the Subcommittee on Fossil and Synthetic Fuels of the House Committee on Energy and Commerce, February 10, 1983, p. 3.

focus must be how best to achieve that dream, consistent with the public interest.

II. The NARUC's Position

The NARUC membership generally shares the consensus of many that the NGPA's chief defects revolve around its perpetuation of pipeline unaccountability in the natural gas industry. Through the operation of Section 601, as interpreted by the FERC, pipeline companies are able to recover automatically their purchased gas costs, even if the company has failed to obtain the lowest cost supplies available to it. This unaccountability problem is greatly exacerbated by the fact that pipelines usually assure their supplies by means of relatively long-term contracts with natural gas producers. Producer-pipeline contracts routinely include provisions which guarantee the producer a constant cash flow, regardless of the marketability of the gas sold under the contract, but which make it very difficult for the pipeline to respond to market changes. I refer, of course, to indefinite price escalator, take-or-pay, and most-favored-nation clauses. With the assurance of automatic purchased gas costs passthrough, the pipeline has no real incentive to avoid such onerous contract terms. The risk is shifted to the distribution companies, and ultimately, to their ratepayers.

State regulators share the view that in other respects as well, Federal natural gas regulation has unjustifiably thwarted the States' exercise of their regulatory responsibilities with respect to retail gas sales. We would place the NGPA's Title II, containing mandatory incremental pricing provisions, among the prime examples of such unnecessary impingement. The NARUC strongly opposed inclusion of these provisions in the NGPA when the law was under consideration in 1978, on the grounds that mandatory incremental pricing would result in higher rates to residential users due to consequent reduction of industrial gas use, and that it constituted an unwarranted first-time intrusion of Federal control into this aspect of retail ratemaking. We are convinced that the passage of time has only made these arguments more persuasive.

In addition, we feel strongly that the FERC's failure to fully exercise its authority to require producer-pipeline contracts to be filed with the Commission, and to make material terms of those contracts publicly available, has made the States' task of evaluating the reasonableness of distribution company purchasing practices unnecessarily difficult. The NARUC petitioned the FERC in March 1982 to implement such filing requirements, a request which the Commission has yet to act upon.[3] Without the opportunity to examine these contracts, the State commissions are precluded from knowing how the major cost component in a gas rate case is computed.

On the other hand, many State regulators have reached the conclusion that the time has come for the Federal government to begin active consideration of ways to reduce the monopsony position of natural gas pipelines within the industry. Some believe that moving toward some form of mandatory contract carriage for pipelines is the only viable way to make producer prices sensitive to market conditions. Others of us are less convinced that distribution companies as well as the Federal/State regulatory apparatus are really ready to handle effectively such a dramatic structural change in the gas industry. I believe it is fair to say, however, that to virtually all of us, the concept of increasing gas utilities' competitive options in the gas supply market is an attractive one that deserves serious consideration.

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[3] The NARUC petition for rulemaking was filed in FERC Docket No. RM-82-20. The Commission referenced the NARUC petition, *inter alia*, in its April 28, 1982 Notice of Inquiry on Impact of the NGPA on Natural Gas Markets (Docket No. RM82-26).

Based on the positions I have just outlined, the NARUC, through its policy-making Executive Committee, this week endorsed without dissent an original package of proposed legislation to amend the NGPA. A copy of the NARUC's proposed legislation, entitled the Natural Gas Fair Marketing Act of 1983, is attached to my prepared statement as an appendix. Under our bill, the following changes in the NGPA would be made:

- The definition of "abuse" under Section 601 of the NGPA would be broadened to include imprudence as well as any contract which materially prevents a pipeline from responding to market forces;
- A determination by the FERC that a contract provision constitutes abuse would automatically void that contract provision;
- Indefinite price escalator clauses in producer-pipeline contracts (existing and future) would be voided;
- A pipeline "market-out" clause would be deemed included in all existing producer-pipeline contracts;
- Volume adjustment contractual rights would be deemed included in all existing contracts with take-or-pay provisions, which would permit a pipeline to reduce "take" obligations up to 50 percent of contracted deliveries, starting with highest-cost gas; failure to exercise this right would constitute a rebuttable presumption of "abuse" under NGPA Section 601;
- Pipelines which exercise their volume adjustment right would be required to provide transportation of the refused gas deliveries for the producer, with compensation at five cents per MMBtu's plus reasonable costs, unless a different rate is established by the FERC or the appropriate State agency;

- The FERC would be directed, in cooperating with the NARUC and its members, to "endeavor to restructure relationships" between pipelines and distributors so as to enhance competitive options;
- The FERC would also be directed to issue regulations requiring that all producer-pipeline contracts be filed with the Commission and that the material terms of such contracts be made publicly available; and
- The incremental pricing provisions of the NGPA would be repealed.

I want to emphasize to the Committee that this package of proposed NGPA amendments represents a compromise position supported by State regulators with widely varying perspectives on natural gas pricing problems. Though some of us individually might advocate additional or different NGPA revisions, we think it highly significant that so many of us have been able to agree on proposed legislation of a relatively far-reaching nature. Senators and House members of both parties have already expressed interest in formally introducing the NARUC bill. We urge your careful consideration of the consensus approach which it reflects.

III. Comparison of NARUC Proposal with Pending Senate Legislation

I would like to turn now to a brief discussion of the relative merits of the various bills pending before this Committee which address natural gas pricing policy.[4] The NARUC is in the relatively pleasant position of finding at least some aspect of most of these bills to parallel provisions of our own legislative proposal just described. While we prefer the approach embodied in our proposal, it should be stressed that the Association may well be able to support some of the very useful ideas contained in pending legislation that have not been explicitly addressed in the NARUC bill.

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[4] In light of the fact that the NARUC has taken no formal position as of yet on Federal pricing policy with respect to imported natural gas, our testimony does not address S. 370, a bill proposing the Imported Liquefied Natural Gas Policy Act of 1983.

A. Broadening the Definition of "Abuse"

Under the NARUC's proposed bill, the problem of pipeline unaccountability is dealt with in several ways. First, Section 3 would require more stringent evaluation by the FERC of a pipeline's purchasing practices by broadening the grounds for denying automatic passthrough of purchased gas costs in PGA cases. Included in this expanded definition of "abuse" would be mis-representation or imprudence on the part of the pipeline and failure to bargain at arms-length with producers. It would also encompass "the entering into of or operating pursuant to" a producer-pipeline contract which materially prevents the pipeline from responding to market changes.

This proposal has been included in almost identical form as part of S. 239, a bill sponsored by Senators Jepsen and Grassley. The NARUC bill goes one step further than does S. 239 by providing that contract provisions found by the FERC to constitute "abuse" under NGPA Section 601 would be automatically voided.

Both S. 60 and S. 291 would also broaden the definition of abuse to include pipeline imprudence. Given the severity of the contracts problem as well as the FERC's probable reluctance to intervene decisively without explicit Congressional direction, we believe it is important that overly restrictive contracts be expressly defined as abusive in the NGPA as well.

An intelligent alternative means to ensure stricter FERC scrutiny of pipeline purchasing practices is contained in S. 689, sponsored by Senator Heinz. This bill would add a new Section 601(d) to the NGPA which provides that Sections 4 and 5 of the Natural Gas Act are expressly applicable to "natural gas companies" regulated under that Act. According to Senator Heinz's analysis, this amendment would mandate prudent pipeline practices and would clarify the Commission's authority to review pipelines' purchased gas costs under the familiar "just and reasonable" standards.

B. Treatment of Indefinite Price Escalator Clauses

With respect to indefinite price escalator clauses in producer-pipeline contracts, the Heinz bill's relevant provision is substantially the same as that in the NARUC's proposed bill. Both would declare all such clauses, in existing and future contracts, to be null and void. The NARUC bill's definition of such clauses is broad enough to encompass most-favored-nation clause contract provisions as well. In addition, in order to take into account possible extenuating circumstances, the NARUC proposal adds regulatory flexibility to this statutory mandate: it would allow the FERC to reinstate an offending contract provision "for good cause shown."

Three other Senate bills which address this issue would place the determination of all indefinite price escalator clauses' legitimacy with the FERC. S. 60 would grant the Commission authority to abrogate or modify these contract provisions; likewise, S. 239 would establish a rebuttable presumption that a contract is abusive under NGPA Section 601 if it contains an indefinite price escalator. S. 291, on the other hand, would suspend indefinite price escalators and allow the Commission to reinstate them, but only for pre-enactment contracts under very limited circumstances. We are inclined to agree with the latter bill's authors that strong medicine, not merely adminsitrative discretion, is called for to deal expeditiously with this particular contract problem.

C. Inclusion of Market-Out Clauses

Reflecting our view that the public interest requires a limited "bail-out" of pipelines from inequitable contracts with producers at this time, the NARUC's proposed bill would declare that all such contracts existing as of the date of enactment will be deemed to include a renegotiation or "market-out" clause. Only the pipeline would be granted the right to exercise this clause. In light of the reality that most existing producer-pipeline contracts are generally skewed in favor of the producer, we think this one-way remedy is preferable to a bilateral market-out provision.

None of the pending Senate legislation embodies precisely this approach to the market-out question. S. 239 would establish a rebuttable presumption that a contract constitutes "abuse" under the NGPA if it has no market-out clause. The Administration's bill, S. 615, proposes that a bilateral market-out clause be included during 1985 only in all contracts existing as of the date of enactment. S. 615 also includes a 45-day notice requirement for exercising the statutory market-out right. In addition, it would require that a pipeline which is party to a contract so terminated must transport gas for the producer-party in an amount not to exceed deliveries under the canceled contract for a one-year period.

Compensation for fulfilling this transportation obligation, which could be limited by order of the FERC or the State agency with jurisdiction over the pipeline, would be 5 cents per MMBtu's plus costs, or as established by the FERC or State agency. In no case, however, could this compensation be required to be flowed through to the pipeline's customers.

A similar approach to automatic market-out provisions is included in S. 689. The Heinz bill would provide a bilateral market-out clause in all existing and future contracts for "new" gas to be deregulated under the current NGPA schedule. Exercise of this right by the pipeline would create an obligation on its part to use its "best efforts" to transport the refused gas. Under S. 689, a 5 cent-per-MMBtu's rate is also mandated; however, in direct contrast to the Administration's bill, it would require that any compensation above that rate (plus costs) must be flowed through to the pipeline's customers.

About these market-out proposals, the following should be noted from the NARUC's perspective:

- S. 239's rebuttable presumption that all contracts are abusive without a market-out clause is an overbroad remedy which would unduly restrict the contractual arrangements of parties to all future gas purchase contracts.

- While S. 615's mandatory transportation right may well be a useful addition to the market-out right, the regulatory implications of enforcing the right where the parties have terminated their contractual relationship have yet to be fully explored.

- Though S. 689's "best efforts" transportation right appears at first to be more easily enforced than a "must carry" right, its ambiguity may be its undoing, in both regulatory and judicial forums.

- The statutory restrictions in S. 615 and S. 689 regarding regulatory treatment of transport compensation are both inflexible and inappropriate intrusions on the ratemaking responsibilities of Federal and State regulatory bodies.

D. Take-or-Pay Contract Provisions

Not suprisingly, most of the pending Senate bills include provisions which would adjust the operation of take-or-pay clauses in producer-pipeline clauses. The NARUC's proposed bill also addresses this issue, but in a way which we believe is more effective than any approach contained in the Senate legislation. I would like to note, however, that we have drawn heavily on a House-introduced bill, H.R. 4, sponsored by Representative Bob Michel of Illinois,[5] in crafting our remedy for the very serious take-or-pay contract problem.

Under this portion of the NARUC bill, pipelines which are party to existing contracts would be permitted to reduce their take-or-pay obligations to 50 percent of deliveries contracted for, starting with the highest-cost gas first. Also, this volume adjustment right would be required to be exercised with respect to any affiliated production purchases equal to or higher in cost than other contracted supplies. In the most significant departure from the Michel bill, an interstate's failure to exercise the take-or-pay adjustment right would create a rebuttable presumption of abuse as defined under the NGPA.

While our bill would grant the pipeline the right to reduce its "take" obligations, it would also provide the producer with a guarantee that gas refused under this or any contract volume adjustment right must be transported by the pipeline who so refuses. We believe this to be not only an equitable approach which treats both producers and pipelines evenhandedly, but which will produce beneficial results for gas consumers as well.

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[5] In the 97th Congress, this legislation was H.R. 7122, sponsored by former Representative Clarence Brown of Ohio.

E. Enhancement of Distribution Companies' Competitive Options

As mentioned previously, the State regulatory community supports serious consideration of alternatives to enhance the competitive options of gas distribution companies. Section 8 of our proposed legislation reflects this conclusion. This provision would require the FERC to cooperate with the NARUC in endeavoring to restructure relationships between pipelines and distribution companies "for the purpose of reducing gas distribution purchase costs through increased reliance on market forces." The ultimate goal--to encourage gas utilities to seek the least expensive supply of natural gas from a variety of sellers--as well as a prohibition on pipeline discrimination against other gas suppliers--clearly envisions that the role of pipelines in the industry is to be changed. We believe it appropriate to leave the specifics of such modification to the FERC's studied administrative discretion, working with our Association, at this time.

We would note that reliance on careful regulatory consideration of new ways to foster market-sensitive natural gas pricing is a feature of several Senate bills as well. S. 60 would require FERC to establish an incentive rate of return to encourage lowest-cost gas purchases by pipelines. Likewise, S. 689 would require FERC to undertake a "tariff" study, which would include an analysis of the responsiveness of wellhead prices to retail market conditions.

The Administration's bill, on the other hand, would initiate mandatory interstate pipeline contract carriage by FERC order. We are not prepared to voice full-fledged opposition to this approach; however, there is no minimizing the breadth of this experiment in industry restructuring. The members of the NARUC would welcome a closer look at this solution to the gas industry's anticompetitive aspects. As reflected in Section 8 of our bill, however, we believe that statutorily defining the rules of the game before a thorough regulatory groundwork has been laid is simply unwise at best, and at worst, potentially disastrous for the industry and its consumers.

F. Federal Facilitation of State Retail Gas Rate Regulation

I will not dwell on the NARUC's previously mentioned position that repeal of incremental pricing and requiring terms of producer-pipeline contracts to be made publicly available are essential to a Federal natural gas policy which facilitates rather than hinders State regulation of retail gas sales. These convictions have been translated into legislative language in the NARUC bill's Sections 9 and 10. Ironically, the Administration's bill cuts both ways on these questions: it would repeal the NGPA's incremental pricing provisions, but it would also repeal the FERC's authority to require the filing of producer-pipeline contracts. In contrast, another Senate bill, S. 689, would go even further than the NARUC has advocated with respect to contract filing: instead of requiring the FERC to make the material terms of such contracts available, the Heinz bill would require the Commission to make the contracts themselves public "in an orderly fashion".

IV. Conclusion

Congress must soon make some fundamental decisions about the future of the natural gas industry. These decisions should not be made with undue emphasis on the short-term problems of the industry, nor should they be made without full recognition of the circumstances and special problems of utilities and PUCs. The increases in prices of gas in recent years and the increasing competitiveness of gas at the burner-tip have changed in fundamental ways the economic circumstances of gas utilities. These forces have, as a consequence, increased noticeably the complexity of State PUC regulation.

The NARUC firmly believes that enactment of the Association's legislative proposals I have discussed today would represent a constructive move toward the regulatory environment which the public interest requires--today as well as in the future.

Thank you for your attention.

Appendix A

A BILL

To amend the Natural Gas Policy Act of 1978 to clarify the definition of abuse, to restrain natural gas price increases by facilitating price responsiveness during periods when supplies exceed demand, to enhance competitive options for local distribution companies in purchasing the least expensive natural gas available, to repeal the incremental pricing of natural gas, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

Section 1. This Act may be cited as the "Natural Gas Fair Marketing Act of 1983".

FINDINGS AND PURPOSE

Section 2. (a) The Congress finds that:

(1) problems of market imbalance threaten the natural gas industry;

(2) such problems are likely to result in natural gas users being burdened by excessively high prices;

(3) interstate commerce is significantly affected by such problems;

(4) an urgent need exists to provide immediate relief from natural gas contract provisions which contribute to those problems; and

(5) adequate information regarding the operation of the natural gas market is not available to the Congress and the public.

(b) The purpose of this Act is to correct imbalances in the natural gas market in order to restrain prices charged to natural gas users by:

(1) defining "abuse" in the Natural Gas Policy Act of 1978, and to protect natural gas users from the results thereof;

(2) eliminating indefinite price escalator provisions in natural gas contracts;

(3) providing a market-out provision to every natural gas pipeline company when the natural gas is not marketable at the contract price;

(4) providing every natural gas pipeline company with the legal ability to reduce the deliveries of high-priced natural gas down to 50 per centum of contract volume whenever the pipeline has more supply than demand;

(5) requiring that any pipeline wishing to exercise such contract right shall exercise it first against its highest price source of natural gas and any contracts it may have for supplies with producing companies affiliated with the pipeline company;

(6) providing a producer the ability to transport natural gas to another purchaser in any case in which the pipeline that had contracted for that natural gas does not accept delivery because its supply exceeds its demand;

(7) enhancing the competitive options for local distribution companies in purchasing the least expensive supplies of natural gas available;

(8) requiring the filing with the Federal Energy Regulatory Commission of all contracts for the first sale of natural gas for public disclosure; and

(9) repealing the incremental pricing provisions of the Natural Gas Policy Act of 1978.

DEFINITION OF ABUSE; EFFECT

Section 3. (a) Section 2 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3301) is amended by adding at the end thereof the following:

"(38) ABUSE.--The term "abuse' includes misrepresentation, imprudence on the part of the pipeline, failure by a pipeline to bargain at arms-length with any producer, and the entering into of or operating pursuant to any contract by any pipeline with any producer if such contract materially prevents the pipeline from responding to changes in customer demand or other market forces.".

(b) Section 601 of the Natural Gas Policy Act of 1978 (15 U.S.C. 3431) is amended by striking the period at the end and inserting in lieu of the period: ", which determination shall void any contract provision based upon such grounds.".

Section 4. Title III of the Natural Gas Policy Act of 1978 (15 U.S.C. 3361-3375) is amended by inserting at the end thereof the following new section:

"SECTION 316. INDEFINITE PRICE ESCALATOR PROVISIONS DECLARED VOID IN NATURAL GAS CONTRACTS.

"Any price provision in any present or future contract for the first sale of natural gas to any pipeline, which does not establish a specific unit price predictable with certainty at any present and future time over the duration of the contract, shall be of no force or effect, unless otherwise determined by the Commission for good cause shown.".

Section 5. Title III of the Natural Gas Policy Act of 1978 is amended by inserting at the end thereof the following new section:

"SECTION 317. NATURAL GAS CONTRACTS DEEMED TO INCLUDE MARKET-OUT PROVISION.

"Any present contract for the first sale of natural gas to any pipeline shall be deemed to allow the pipeline to escape the contract or to negotiate a new lower price if the natural gas is not marketable at the contract price, unless otherwise determined by the Commission for good cause shown.".

Section 6. Title III of the Natural Gas Policy Act of 1978 is amended by inserting at the end thereof the following new section:

"Sec. 318. NATURAL GAS CONTRACTS DEEMED TO INCLUDE ADJUSTMENT PROVISION TO REDUCE PURCHASE REQUIREMENTS.

"(a) INCLUSION.--Any present contract for the first sale of natural gas to any pipeline shall be deemed to include the contract provisions set forth in subsection (b), unless othewise determined by the Commission for good cause shown.

"(b) PURCHASE REQUIREMENT ADJUSTMENT PROVISION.--The contract provisions deemed included in any contract described in subsection (a) are as follows:

"(1) GENERAL RULE.--The pipeline may, without obligation to pay, exercise a right not to accept delivery of any portion of the volume of natural gas which the pipeline has contracted to accept, if the pipeline has determined that it cannot market the total volume of natural gas contracted for.

"(2) AMOUNT OF REDUCTION.--The pipeline may not reduce, pursuant to these contract provisions, the volume of natural gas the pipeline accepts delivery of below a level equal to 50 per centum of the volume the pipeline contracted to take delivery of under the contract (without regard to any previous reduction under these contract provisions).

"(3) HIGHEST PRICED GAS REDUCED FIRST.--Except as provided in paragraph (4), the pipeline may not reduce under these contract provisions the volume of natural gas the pipeline accepts delivery of if the pipeline has not exercised its right under these provisions to reduce (to the maximum extent permitted under paragraph (2)) the volume of natural gas the pipeline has contracted to take delivery of at a higher price under any other contract.

"(4) AFFILIATED PRODUCERS.--The pipeline may not reduce under these contract provisions the volume the pipeline has contracted to take delivery of if the pipeline has not exercised its right under these provisions to reduce (to the maximum extent permitted under paragraph (2)) the volume of natural gas the pipeline has contracted to take delivery of at the same or a higher price under any other contract between the pipeline and any affiliate of the pipeline.

"(5) CONTRACTED TO TAKE DEFINED.--For purposes of these contract provisions, the term 'contracted to take' refers to the volume of natural gas of which the pipeline has contracted to take delivery under a contract (whether or not the pipeline is obligated under the contract to pay for any lesser volume in the event delivery is not taken).

"(6) EFFECT OF TAKE-OR-PAY AND MINIMUM-BILL PROVISIONS.--Any provision of any contract shall not apply to the extent it requires a pipeline to pay any fee or other charge with respect to any natural gas for which delivery is not taken pursuant to these contract provisions.

"(7) CONTRACTS COVERING MORE THAN ONE CATEGORY OF NATURAL GAS.--Any contract establishing two or more categories of natural gas for purposes of pricing the natural gas delivered under the contract shall be treated as separate contracts for each such category.

"(c) EFFECT OF FAILURE TO EXERCISE CONTRACT PROVISION.--The failure to exercise the contract provisions in subsection (b) of this section by any pipeline under the jurisdiction of the Commission shall create a rebuttable presumption that such failure constitutes abuse, as defined in section 2(38) of this Act.

"(d) FIELD DRAINAGE, CASING HEAD OR OTHER SIMILAR REQUIREMENTS.--The contract provisions in subsection (b) of this section shall not apply to the purchase of natural gas when it is determined by the Commission to be justified because of field drainage, casing head or other similar requirements.".

Section 7. Title III of the Natural Gas Policy Act of 1978 is amended by inserting at the end thereof the following new section:

"SEC. 319. NATURAL GAS CONTRACTS DEEMED TO INCLUDE TRANSPORTATION OBLIGATION TO SECONDARY PURCHASERS.

"(a) INCLUSION.--Any present or future contract for the sale of natural gas to any pipeline shall be deemed to include the contract provisions set forth in subsection (b), unless otherwise determined by the Commission for good cause shown.

"(b) TRANSPORTATION OBLIGATION CLAUSE.--The contract provisions deemed included in any contract described in subsection (a) are as follows:

"(1) GENERAL RULE.--Whenever the pipeline has exercised its right under any contract provision (including the contract provisions provided under section 318 of the Natural Gas Policy Act) to reduce the volumes of natural gas the pipeline is obligated to take delivery of on the grounds that the pipeline cannot market the total volumes for which it is so obligated for, the pipeline shall provide, on behalf of the seller, transportation of any of the volume of natural gas--

"(A) which is involved in the reduction,

"(B) which is resold by the seller to another purchaser, and

"(C) which the pipeline would be required to pay for in the absence of the exercise of such contract provision.

"(2) TERMS AND CONDITIONS.--The terms and conditions of such transportation shall be in accordance with regulations prescibed by the Commission.

"(c) CONSIDERATION.--The consideration for any transportation provided under the contract provisions stated by this section shall be at $.05 per million Btu's plus the cost of such transportation, as established by the appropriate State or Federal regulatory body, unless such regulatory body has established, by rule, a different rate as just compensation for such transportation.".

Section 8. Title III of the Natural Gas Policy Act of 1978 is amended by inserting at the end thereof the following new section:

"SEC. 320. ENHANCING COMPETITIVE OPTIONS FOR LOCAL DISTRIBUTION COMPANIES IN THE PURCHASE OF NATURAL GAS.

(a) The Commission, in cooperation with the affected State commissions and the national organization of the State commissions, shall endeavor to restructure relationships between pipelines and local distribution companies for the purpose of reducing gas distribution purchase costs through increased reliance on competitive market forces. Local distribution companies shall be encouraged to seek the least expensive supply of natural gas from among the pipelines, producers of natural gas and others. A pipeline shall not discriminate between its own gas and that of others in providing transmission, storage and brokerage services for local distribution companies.

(b) The Commission shall report annually to the Congress on the accomplishments under this section and the need for additional legislation.

FILING OF CONTRACTS

Section 9. Section 315(c) of the Natural Gas Policy Act of 1978 (15 U.S.C. 3375(c)) is amended to read as follows:

"(c) FILING OF CONTRACTS.--Within 180 days of the enactment of this subsection, the Commission shall issue final regulations to require any first sale purchaser of natural gas under a present or future contract to file with the Commission a copy of such contract. Such regulations shall assure reasonable public access to all terms of such contracts which may materially affect the retail rates for which natural gas under such contract is sold.".

REPEAL OF INCREMENTAL PRICING

Section 10. (a) REPEALER.--Title II of the Natural Gas Policy Act of 1978 (15 U.S.C. 3341-3348) is hereby repealed.

(b) TECHNICAL AND CONFORMING AMENDMENTS.--

(1) Section 121(b) of such Act (15 U.S.C. 3331(b)) is amended--

(A) by striking out "Effective beginning on the effective date of the incremental pricing rule required under section 201, the" and inserting in lieu thereof "The"; and

(B) by striking out "shall cease to apply" and inserting in lieu thereof "shall not apply".

(2) Section 502 of such Act (15 U.S.C. 3412) is amended by striking out subsection (d).

(3) Section 504(b) of such Act (15 U.S.C. 3414(b)) is amended--

(A) by striking out paragraph (3) and redesignating subsequent paragraphs accordingly;

(B) in paragraph (1), by striking out "paragraphs (2) and (3)" and inserting in lieu thereof "paragraph (2)"; and

(C) in paragraph (3) (as designated), by striking out "paragraph (1), (2), or (3)" and inserting in lieu thereof "paragraph (1) or (2)".

(4) Section 506 of such Act (15 U.S.C. 3416) is amended by striking out subsection (d).

(5) Section 507 of such Act (15 U.S.C. 3417) is repealed.

(6) Section 601(c)(2) of such Act (15 U.S.C. 3431(c)(2)) is amended--

(A) by striking out "--(A)" and inserting in lieu thereof a comma;

(B) by striking out "and" at the end of former subparagraph (A); and

(C) by striking out "(B) such recovery is not inconsistent with any requirement of any rule under section 201 (including any amendment under section 202),".

(7) The table of contents for such Act is amended by striking out the items relating to title II and the item relating to section 507.

(c) REMEDIAL ACTION.--Effective beginning on the date of the enactment of this section, each interstate pipeline and local distribution company which was formerly subject to the provisions of title II of the Natural Gas Policy Act of 1978 shall take the following actions:

(1) Each such interstate pipeline shall clear both its unrecovered incremental gas costs account and its unrecovered incremental surcharges account of all amounts accumulated therein by--

(A) transferring, as of such date of enactment, all such amounts to its unrecovered purchased gas costs account,

(B) proceeding to collect all such amounts in due course pursuant to regulations prescribed by the Federal Energy Regulatory Commission (hereinafter in this subsection referred to as the "Commission"), and

(C) doing all such other acts as the Commission may prescribe for the purpose of effecting the repeal of title II of such Act as of the date of the enactment of this Act.

(2) Each such local distribution company shall clear both the unrecovered incremental gas costs acaccount and the unrecovered incremental surcharges account of all amounts accumulated therein by--

(A) transferring, as of such date of enactment, all such amounts to the account to which the company's purchased gas costs are ordinarily debited, and then

(B) proceeding to collect all such amounts in due course, whether pursuant to pertinent regulations prescribed therefor by the regulatory body having jurisdiction over such company's rates and charges, or otherwise.

(d) NO FURTHER INCREMENTAL PRICING PERMITTED.--Effective beginning on the date of the enactment of this Act, no interstate pipeline or distribution company which was formerly subject to the provisions of title II of such Act shall--

(1) debit any amount to any unrecovered incremental gas costs account;

(2) debit any amount to any unrecovered incremental surcharges account;

(3) bill incremental pricing surcharges to any customer under the authority of such provisions; or

(4) otherwise comply with the provisions of part 282 of title 18 of the Code of Federal Regulations or other regulatory provisions which implement title II of such Act.

(e) DEFINITIONS.--For purposes of this section--

(1) the term "unrecovered incremental gas costs account" means the account designated as Account 192.1 of the Uniform System of Accounts Prescribed for Natural Gas Companies, parts 201 and 204 of title 18 of the Code of Federal Regulations;

(2) the term "unrecovered incremental surcharges account" means the account designated as Account 192.2 of the Uniform System of Accounts Prescribed for Natural Gas Companies, parts 201 and 204 of such title 18; and

(3) the term "unrecovered purchased gas costs account" means the account designated Account 191 of the Uniform System of Accounts Prescribed for Natural Gas Companies, of such parts 201 and 204.

(A) by striking out paragraph (3) and redesignating subsequent paragraphs accordingly;

(B) in paragraph (1), by striking out "paragraphs (2) and (3)" and inserting in lieu thereof "paragraph (2)"; and

(C) in paragraph (3) (as designated), by striking out "paragraph (1), (2), or (3)" and inserting in lieu thereof "paragraph (1) or (2)".

(4) Section 506 of such Act (15 U.S.C. 3416) is amended by striking out subsection (d).

(5) Section 507 of such Act (15 U.S.C. 3417) is repealed.

(6) Section 601(c)(2) of such Act (15 U.S.C. 3431(c)(2)) is amended--

(A) by striking out "--(A)" and inserting in lieu thereof a comma;

(B) by striking out "and" at the end of former subparagraph (A); and

(C) by striking out "(B) such recovery is not inconsistent with any requirement of any rule under section 201 (including any amendment under section 202),".

(7) The table of contents for such Act is amended by striking out the items relating to title II and the item relating to section 507.

(c) REMEDIAL ACTION.--Effective beginning on the date of the enactment of this section, each interstate pipeline and local distribution company which was formerly subject to the provisions of title II of the Natural Gas Policy Act of 1978 shall take the following actions:

(1) Each such interstate pipeline shall clear both its unrecovered incremental gas costs account and its unrecovered incremental surcharges account of all amounts accumulated therein by--

(A) transferring, as of such date of enactment, all such amounts to its unrecovered purchased gas costs account,

(B) proceeding to collect all such amounts in due course pursuant to regulations prescribed by the Federal Energy Regulatory Commission (hereinafter in this subsection referred to as the "Commission"), and

(C) doing all such other acts as the Commission may prescribe for the purpose of effecting the repeal of title II of such Act as of the date of the enactment of this Act.

(2) Each such local distribution company shall clear both the unrecovered incremental gas costs ac- account and the unrecovered incremental surcharges account of all amounts accumulated therein by--

(A) transferring, as of such date of enactment, all such amounts to the account to which the company's purchased gas costs are ordinarily debited, and then

(B) proceeding to collect all such amounts in due course, whether pursuant to pertinent regulations prescribed therefor by the regulatory body having jurisdiction over such company's rates and charges, or otherwise.

(d) NO FURTHER INCREMENTAL PRICING PERMITTED.--Effective beginning on the date of the enactment of this Act, no interstate pipeline or distribution company which was formerly subject to the provisions of title II of such Act shall--

(1) debit any amount to any unrecovered incremental gas costs account;

(2) debit any amount to any unrecovered incremental surcharges account;

(3) bill incremental pricing surcharges to any customer under the authority of such provisions; or

(4) otherwise comply with the provisions of part 282 of title 18 of the Code of Federal Regulations or other regulatory provisions which implement title II of such Act.

(e) DEFINITIONS.--For purposes of this section--

(1) the term "unrecovered incremental gas costs account" means the account designated as Account 192.1 of the Uniform System of Accounts Prescribed for Natural Gas Companies, parts 201 and 204 of title 18 of the Code of Federal Regulations;

(2) the term "unrecovered incremental surcharges account" means the account designated as Account 192.2 of the Uniform System of Accounts Prescribed for Natural Gas Companies, parts 201 and 204 of such title 18; and

(3) the term "unrecovered purchased gas costs account" means the account designated Account 191 of the Uniform System of Accounts Prescribed for Natural Gas Companies, of such parts 201 and 204.

Appendix B

COMPARISON OF NARUC PROPOSED NATURAL GAS LEGISLATION WITH PENDING SENATE BILLS

This overview compares the substantive provisions of the NARUC's proposed legislation to amend the Natural Gas Policy Act of 1978 (NGPA), as approved by the Executive Committee on March 10, 1983, with all bills pending in the Senate as of March 4, 1983. The Senate bills analyzed are:

(1) S. 60, introduced on January 26, 1983 by Sen. Nancy L. Kassebaum (R-Kansas);

(2) S. 239, introduced on January 26, 1983 by Sen. Robert Jepsen (R-Iowa) and Sen. Charles Grassley (R-Iowa);

(3) S. 291, introduced on January 31, 1983 by Sen. John C. Danforth (R-Missouri) and Sen. Thomas F. Eagleton (D-Missouri);

(4) S. 293, introduced on January 31, 1983 by Sen. Eagleton and Sen. Danforth;

(5) S. 615, introduced on February 28, 1983 by Sen. James A. McClure (R-Idaho), on behalf of the Reagan Administration; and

(6) S. 689, introduced on March 3, 1983 by Sen. John Heinz (R-Pennsylvania).

NARUC Bill Provision	Senate Bills with Comparable Provision
Broadens definition of "abuse" under NGPA to include imprudence and entering into or operating pursuant to any contract which materially prevents pipeline from responding to market conditions; automatically voids contract provisions determined to constitute abuse (Section 3)	S. 60 - imprudence only S. 239 - identical to NARUC's S. 291 - imprudence only S. 615 - requires FERC review of PGA passthroughs beyond "allowed rate" (i.e., pipeline's average costs) until 1986 S. 689 - applies Sections 4 and 5 of Natural Gas Act to PGA reviews, authorizing FERC to evaluate pipeline prudence and to use the "just and reasonable" standard

NARUC Bill Provision	Senate Bills with Comparable Provision
Automatically voids price provisions in existing and future contracts which are not tied to specific price (e.g., indefinite price escalator clauses) (Section 4)	S. 291 - suspends such clauses and authorizes FERC to reinstate under limited circumstances for pre-enactment contracts only S. 689 - substantially identical to NARUC's
Includes market-out clause for pipeline only in existing contracts (Section 5)	S. 239 - establishes rebuttable presumption that contract constitutes abuse under NGPA if it has no market-out S. 615 - bilateral market-out clause included during 1985 only in existing, non-renegotiated contracts; 45-day notice requirement; pipeline incurs transportation obligation, with FERC or State agency permitted to modify; compensation: 5 cents per MMBtu's plus costs, or as established by FERC or State agency; no flow-through of any of transportation compensation to pipeline customers S. 689 - bilateral market-out in all existing and future contracts for new gas (with some intrastate gas excepted); 30-day notice requirement; "best-efforts" transportation right incurred by pipeline if clause exercised; compensation: 5 cents per MMBtu's plus costs, or as established by FERC or State agency; compensation over 5 cents rate must be flowed through to pipeline customers
Take-or-pay obligations in existing contracts may be reduced to 50 percent, starting with highest-cost gas; failure to exercise constitutes rebuttable presumption of abuse (Section 6)	S. 60 - T/P provision's inclusion in contract taken into account by FERC in PGA and Sections 4 and 5 rate cases; may order modification or rescission S. 239 - creates rebuttable presumption that contracts with T/P clauses constitute abuse S. 291 - T/P clauses are suspended, with limited FERC

NARUC Bill Provision	Senate Bills with Comparable Provision
	authority to reinstate for pre-enactment contracts S. 615 - permits T/P reduction to 70 percent in existing, non-renegotiated contracts; 30-day notice requirement; producer given market-out when pipeline reduces takes; FERC may waive reduction right for drainage or similar reasons; casinghead NG exempted S. 689 - T/P clauses in existing contracts deemed by operation of law to be limited to 50 percent
Transportation must be provided for gas refused under volume adjustment right for T/P clauses provided in Section 6; compensation: 5 cents per MMBtu's plus costs, or as established by FERC or State agency (Section 7)	S. 615 - FERC given authority to order interstate pipelines to carry gas of others; compensation: 5 cents per MMBtu's, plus costs, or as established by FERC; no flow-through of any of compensation
FERC ordered to study, in cooperation with NARUC and States, ways to restructure relationships between pipelines and distributors to enhance latter's competitive options (Section 8)	S. 60 - requires FERC to establish an incentive rate of return to stimulate lowest-cost gas purchasers S. 615 - mandatory contract carriage for interstate pipelines by FERC order (see previous section) S. 689 - requires FERC to establish "rate increase disincentive"; requires FERC to undertake a "tariff study" including responsiveness of wellhead prices to retail market conditions
Requires FERC to issue reg's to require filing of contracts and make public all material terms (Section 9)	S. 615 - repeals FERC authority to require contract filing S. 689 - substantially identical to NARUC's
Repeals incremental pricing provisions of NGPA (Section 10)	S. 615 - substantially identical to NARUC's

The **CHAIRMAN**. Thank you very much.

Mr. Lederer?

STATEMENT OF BRIAN J. H. LEDERER, PEOPLE'S COUNSEL OF THE DISTRICT OF COLUMBIA AND THE OFFICE OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES

Mr. **LEDERER**. Thank you, sir. Senator McClure and members of the committee, I appreciate the opportunity to testify. My name is Brian Lederer. I am People's Counsel in the District of Columbia testifying on behalf of the Office of the People's Counsel of the District of Columbia and of the National Association of State Utility Consumer Advocates, which is a national association of some 30 State——

Senator **METZENBAUM**. I can hear you but I can do a lot better if you pull that closer.

Mr. **LEDERER**. Thank you, sir.

Senator **METZENBAUM**. That's better.

Mr. **LEDERER**. Testifying on behalf of the Office of the People's Counsel of the District of Columbia, and of the National Association of State Utility Consumer Advocates, a national association of some 30 State public utility counsel; the topic for this committee, that of the proper pricing and structuring of the natural gas market, is an important one, and I appreciate the opportunity to be here on behalf of the Office of People's Counsel and the ratepayers of the District of Columbia as well as the 29 other State officials who represent the gas customers at the State level.

Just to provide some background for the committee, the Office of the People's Counsel of the District of Columbia is a public agency created by Congress to represent all of the customers—business, institutional, and residential—of the gas, telephone, and electric utilities doing business in the District of Columbia and regulated by the District of Columbia Public Service Commission.

As People's Counsel, I am a public official in the District of Columbia nominated by the Mayor with the advice and consent of the City Council and the NASUCA represents State officials similarly situated from States such as Florida, South Carolina, Alaska, Maryland, Pennsylvania, New York, Illinois, Utah, Oklahoma, and Arkansas. This organization, which represents substantial interest at the State level, this organization contains substantial expertise and is politically accountable for its positions.

Now as I understand the purpose of this hearing, it is to build a record and provide guidance for this committee in its deliberations on what should be done concerning the issue of pricing and structuring of the natural gas marketplace. We are clearly here because the structure is not producing results that meet the public interest or the interest of the customers, the regulators, the distribution companies, the pipeline companies, or the producing companies. We are in a situation in which we are facing a series of unproductive political standoffs. Committee solutions are being proposed that are in our opinion win-lose as opposed to win-win, and there is far too much discussion going on in which somehow it is everyone else's problem but our own.

No one can be satisfied with the current structure that we have with natural gas regulation, supply, pricing, and use. We have a natural gas economic structure that turns free enterprise on its head, rewarding inefficiency, encouraging high costs that cannot be marketed, preventing prices from providing accurate signals to customers and suppliers alike, and disrupting the orderly long-term development of natural gas in the energy marketplace.

In seeking a solution to this marketplace nonstructure, we must stop trying to find fixed points and view it more as a process and as a series of elements, each of which must be addressed—the producer's pipeline contracting, the ability of the suppliers to obstruct a market-determined supply, the inability of the customers to have their market-determined use and consumption of gas reflected in the cost and volume of gas delivered, the ability of the noncompetitive marketplace in supply to pass through inefficient levels of inventory and production, the inability of the regulators who regulate the companies serving the consumption marketplace to make efficiency at that end the basis for pricing and supply. Now omission of any of these elements will make it a nonsolution because omission of any of these elements will continue to create problems.

Let me skip a little bit here. The current discussions, as I have said, promote ideas that are only pieces of a solution. In particular, the focus is too much on the alleged benefits of removing price regulation in the abstract without dealing with the other significant obstacles blocking a functioning marketplace. As a singular proposal, removing all Federal controls on the price of natural gas at the wellhead is not even what I would call a true marketplace solution. This is because——

The CHAIRMAN. The balance of your statement will appear in the record in full. Your time has expired.

[The prepared statement of Mr. Lederer follows:]

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DISTRICT OF COLUMBIA

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TESTIMONY

OF

BRIAN J. H. LEDERER

PEOPLE'S COUNSEL

OF THE DISTRICT OF COLUMBIA

BEFORE THE

UNITED STATES SENATE COMMITTEE

ON ENERGY AND NATURAL RESOURCES

March 13, 1983

Senator McClure, Members of the Committee:

My name is Brian Lederer. I am People's Counsel of the District of Columbia, testifying on behalf of the Office of the People's Counsel of the District of Columbia and of the National Association of State Utility Consumer Advocates (NASUCA), a national association of some thirty state public utility counsel. The topic for this committee, that of proper pricing and structuring of the natural gas market, is an important one. I appreciate the opportunity to be here on behalf of OPC and the 29 other state officials who represent the gas customers at the state level.

Just to provide some background for your committee: The Office of the People's Counsel of the District of Columbia is a public agency created by Congress to represent all of the customers--business, institutional, and residential--of the gas, telephone and electrical utilities doing business in the District of Columbia and regulated by the District of Columbia Public Service Commission. As People's Counsel, I am a public official in the District of Columbia, nominated by the Mayor with the advice consent of the City Council. NASUCA represents state officials similarly situated from states such as Florida, South Carolina, Alabama, Maryland, Pennsylvania, New York, Illinois, Utah, Oklahoma, and Arkansas. This organization represents substantial interests at the state level. This organization contains substantial expertise and is politically accountable for its positions.

As I understand the purpose of this hearing, it is to build the record and provide guidance for this committee and its deliberations on what should be done concerning the issue of the pricing and structuring of the natural gas market place. We are here because the structure is not producing results that meet the public interest or the interests of the customers, the regulators, the distribution companies, the pipeline companies or the producing companies. We are in a situation in which we are facing a series of unproductive political stand-offs. Committee solutions are being proposed that are win-lose as opposed to win-win. Too much discussion is going on in which somehow it is everyone's problem but our own.

No one can be satisfied with the current structure that we have with natural gas regulation, supply, pricing and use. We have a natural gas economic structure that turns free enterprise on its head: rewarding inefficiency, encouraging high costs that cannot be marketed, preventing prices from providing accurate signals to customers and suppliers alike, and disrupting the orderly, long-term development of natural gas in the energy marketplace.

In seeking a solution to this marketplace non-structure, we must stop trying to find fixed points and view it more as a process and as a series of elements, each of which addressed: 1) the producer/pipeline contracting; 2) the ability of the suppliers to obstruct a market-determined supply; 3) the inability of the customers to have their market-determined use and consumption of gas reflected in the cost and volume of gas offered for sale; 4) the ability of the noncompetitive marketplace in supply to pass through inefficient levels of inventory and production; 5) the inability of the regulators who regulate the companies serving the consumption marketplace to make efficiency at that end the basis for pricing and supply. Omission of any of the elements makes it a non-solution.

First, as I have already indicated, we must stop the attitude that it is somebody's problem. It is everybody's problem, which requires acknowledging the legitimacy of all the interests. Each interest must pay something in order to find a solution that is fair and equitable.

Second, we must find a way to have the price the customers will pay for gas accurately and timely transmitted to producers, pipelines and distribution companies so they know before the fact what gas and what cost they can market.

Third, we must approve only regulatory, marketing and business practices which recognize simplicity, and which encouraged efficiency in the marketplace at both ends.

None of these factors are being met within the existing structure.

The current discussions promote ideas that are only pieces of a solution. In particular, the focus is too much on the allegel benefits of removing price regulation in the abstract without dealing with the other significant obstacles to a functioning marketplace. As a singular proposal, removing all federal controls on the price of natural gas at the well head is not even what I would call a true marketplace solution. This is because there are other forces at work which in fact block the marketplace from functioning. The result is decontrol by itself would simply run into those market blocks and the price would jump while consumption declined (including desertion all together by the business and industrial customers of the natural gas marketplace, leaving farmers, small businesses and city residents to support the entire natural gas infrastructure.

For example, contracts between the producers, and the pipelines reward the attempt to market high cost gas in the face of declining demand for gas, a result that cannot happen in a properly functioning free market. That block is the structure of delivery to the customer, in which the pipelines have virtually total control over the customers ability to get gas from the production place to their place of use.

In addition, the federal regulatory structure permits the automatic pass through of the high cost gas from the pipeline to the distribution company. This last winter alone, those pass-through costs increased 132% in Washington, D.C., and increased overall bills 15% without regard to any additional bill increases from state public service commission rate decision. There is a further federal regulatory problem. There must be a clearer definition of the public interest purpose of the federal regulation of pipelines as it relates to rate determinations. At least with local distribution companies, one can evaluate their monopoly status and their obligation to provide service. Those two items together provide a framework for effective, efficient regulation. However, at the federal level there is no equivalent real framework: the obligation to serve the market is too broad and general a standard.

Another obstacle to the effective working of the gas supply free market concerns the markets at the local level: those markets provide no reward to the customer or to the distribution company for increased efficiency in the distribution of gas to the customer or for the use of the gas by the customer.

This causes a breakdown in the marketplace of the customer. Those customers who can switch from gas do so and those who cannot simply reduce use any way that they can.

This leads to another interesting block in the proper functioning of the free market: a virtual total thwarting of state regulatory authority and its ability to properly reflect in its regulation the signals from the customer marketplace to the distribution companies in order that they themselves might start structuring delivery of their public service obligation around some efficiency criteria. As a result, reduction in use by the customer is seen as a financial threat to the distribution company. At the same time because of the automatic pass-throughs, because of the control over the supply to the distribution companies by the pipelines and because of their various contract provisions (indefinite price escalators, take or pay obligations) price signals from the market side do not find their way up to those who transmit, those who purchase and those who produce gas.

It is the position of NASUCA, that, unless legislation deals with all the blocks to the effective functioning of the marketplace, there is no solution that is fair functioning or equitable.

There are several items that must be included in resolving these various blockages. First, one must look at the process for structuring a solution, not simply at some fixed in-point. Second, one must get the public, the customer, and the public's preferences translated through the system. Third, one must permit the real public interest, sensitivity and decisional role of state regulation to have affect.

There is too little dicussion of what business these various elements of the marketplace are; there is too little discussion and definition in the context of a free market of the business of each of the elements in the natural gas market place.

There is too much power being given to the federal regulatory agency. I say too much power because it has no real constituency, no real public process in which the real parties in interest (those who actually use gas) have a substantive role, and no clear public interest standard around which to make decisions. At the state level, however, the Public Service Commission is required to balance the company's obligation to serve the customer with the customer's obligation to serve the company.

Clearly there are solutions that would bring the marketplace back to the natural gas industry. These solutions can be fair. If the solution includes measures that truly breakdown all the blocks to a proper transmission of price and cost signals and to the ability of the customer to really decide what gas they get, then removal of complex well-head pricing regulation can be part of it. Otherwise, simply removing the well-head price controls will leave the customers, the distribution companies, state regulators and state public officials with the horrendous problem of sky-rocketing prices and no corresponding efficiencies to control net consumption costs at the user level. Therefore, the system would promote a profit at one end and a deficit at another end (made up by rate increases). That is not an answer that permits long-term stabilization of the natural marketplace, that allows the free marketplace to function and that serves the public interest.

Thank you very much for the opportunity to testify.

The CHAIRMAN. Mr. Simoneaux.

Senator FORD. Mr. Chairman, Senator Johnston asked me to recognize Mr. Simoneaux. He apologizes for not being here today. He was very precise in my ability to pronounce your name, Simoneaux, so we welcome you here. He had other engagements and was prevented from attending.

Mr. SIMONEAUX. Thank you very much. I understood Senator Johnston would not be here today.

With me today is Mr. Harry Barsch, counsel for the State of Louisiana.

STATEMENT OF FRANK P. SIMONEAUX, SECRETARY, LOUISIANA DEPARTMENT OF NATURAL RESOURCES, ACCOMPANIED BY HARRY BARSCH, COUNSEL

Mr. SIMONEAUX. Mr. Chairman, members of the committee, my name is Frank Simoneaux, secretary of the Department of Natural Resources for the State of Louisiana. I am here on behalf of the Governor, the State, as well as the Department of Natural Resources.

We appreciate the opportunity to appear before you to provide you with our views about the proposed natural gas consumer regulatory reform legislation. Natural gas regulatory reform is a high priority for Louisiana, and we applaud the President and the Secretary of Energy for presenting a balanced response to the difficult problems caused by the current regulatory arrangement.

As you have already learned, the NGPA has created distortions and inequities which have affected all parts of the country. Louisiana has been particularly disadvantages by the NGPA. Because Louisiana's intrastate pipelines have no old gas cushion, they have difficulty purchasing new supplies and must charge their customers higher rates than the rates paid by interstate consumers.

Louisiana's major interstate supplier, United Gas Pipeline Co., has exhausted its cushion and is offering gas today at rates which are higher than those charged by most other interstate pipelines. Because of the NGPA, consumers in Louisiana and elsewhere in the country are paying prices above those which would prevail in a free, unregulated market.

It is well known that Louisiana is a major gas producing State. However, it is less well known how important natural gas is to Louisiana consumers and to the State's industrial economy. Louisiana, with only 2 percent of the Nation's population, accounts for 8 percent of total U.S. gas consumption.

Our industrial and employment base depend heavily upon natural gas. Natural gas provides 80 percent of the energy consumed by Louisiana industries. Most of the industrial gas is consumed for process and feedstock uses. For those users, alternate fuels are either technologically infeasible or prohibitively costly.

Louisiana's residential and commercial users also rely predominantly on natural gas.

Because Louisiana is a consuming state and because Louisiana's economy depends upon natural gas, questions relating to the price and availability of gas are of unusual importance to Louisiana. Louisiana, like the rest of the country, needs a national energy policy which will produce adequate supplies of gas at the lowest possible price consistent with that objective. The regulatory policies of the last 30 years have not in our opinion moved us toward that goal. The rigid price controls of the Natural Gas Act created shortages and the complex scheme of regulation created by the NGPA has left a legacy of threatened regional shortages, market distortions, and prices above those which would prevail in a free, unregulated market.

It is our firm conviction that only a free market for natural gas can provide the supplies needed by the American economy at the lowest possible prices to consumers.

We basically support the administration's proposal because it promises relief from the present regulatory nightmare and because it will achieve over time a free market for natural gas. The administration's proposal is well balanced, and it addresses the most difficult problems which have arisen under the NGPA. By removing wellhead price controls on January 1, 1986, while retaining consumer protections, it will permit the market to move toward decontrol in an orderly fashion which is very much needed. It will permit the market to move toward decontrol in an orderly fashion.

We also support the administration's objectives to remove unnecessary restrictions on the use of gas and to remove regulatory obstacles through the free movement of gas.

Because of all of these extremely positive features in the proposal, we urge the committee and Congress to complete the action on the bill as quickly as possible.

While we suppose the major objectives of the bill, there are a number of provisions which we believe should be modified.

The CHAIRMAN. We have your statement and your time has expired.

Mr. SIMONEAUX. We will communicate that with a supplemental statement.

The CHAIRMAN. Thank you. We will receive that. Thank you very much. We may get into some of these in questions as well.

[The prepared statement of Mr. Simoneaux follows:]

Statement of Frank P. Simoneaux, Secretary, Louisiana Department of Natural Resources

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS FRANK P. SIMONEAUX. I AM SECRETARY OF THE DEPARTMENT OF NATURAL RESOURCES OF THE STATE OF LOUISIANA. I AM HERE ON BEHALF OF THE STATE OF LOUISIANA, THE GOVERNOR OF LOUISIANA, AND THE LOUISIANA DEPARTMENT OF NATURAL RESOURCES.

WE APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TO PROVIDE YOU WITH OUR VIEWS ABOUT THE PROPOSED NATURAL GAS CONSUMER REGULATORY REFORM LEGISLATION. NATURAL GAS REGULATORY REFORM IS A HIGH PRIORITY FOR LOUISIANA, AND WE APPLAUD THE PRESIDENT AND THE SECRETARY OF ENERGY FOR PRESENTING A BALANCED RESPONSE TO THE DIFFICULT PROBLEMS CAUSED BY THE CURRENT REGULATORY ARRANGEMENT.

AS YOU HAVE ALREADY LEARNED, THE NGPA HAS CREATED DISTORTIONS AND INEQUITIES WHICH HAVE AFFECTED ALL PARTS OF THE COUNTRY. LOUISIANA HAS BEEN PARTICULARLY DISADVANTAGED BY THE NGPA. BECAUSE LOUISIANA'S INTRASTATE PIPELINES HAVE NO OLD GAS CUSHION, THEY HAVE DIFFICULTY PURCHASING NEW SUPPLIES AND MUST CHARGE THEIR CUSTOMERS HIGHER RATES THAN THE RATES PAID BY INTERSTATE CONSUMERS. LOUISIANA'S MAJOR INTERSTATE SUPPLIER -- UNITED GAS PIPE LINE COMPANY -- HAS EXHAUSTED ITS CUSHION AND IS OFFERING GAS TODAY AT RATES WHICH ARE HIGHER THAN THOSE CHARGED BY MOST OTHER

INTERSTATE PIPELINES. BECAUSE OF THE NGPA, CONSUMERS IN LOUISIANA AND ELSEWHERE IN THE COUNTRY ARE PAYING PRICES ABOVE THOSE WHICH WOULD PREVAIL IN A FREE, UNREGULATED MARKET.[1]

IT IS WELL KNOWN THAT LOUISIANA IS A MAJOR GAS PRODUCING STATE. IT IS LESS WELL UNDERSTOOD HOW IMPORTANT NATURAL GAS IS TO LOUISIANA CONSUMERS AND TO THE STATE'S INDUSTRIAL ECONOMY. LOUISIANA, WITH ONLY TWO PERCENT OF THE NATION'S POPULATION, ACCOUNTS FOR EIGHT PERCENT OF TOTAL U. S. GAS CONSUMPTION.

OUR INDUSTRIAL AND EMPLOYMENT BASE DEPENDS ON NATURAL GAS. NATURAL GAS PROVIDES 80% OF THE ENERGY CONSUMED BY LOUISIANA INDUSTRIES. MOST OF THE INDUSTRIAL GAS IS CONSUMED FOR PROCESS AND FEEDSTOCK USES. FOR THOSE USES, ALTERNATE FUELS ARE EITHER TECHNOLOGICALLY INFEASIBLE OR PROHIBITIVELY COSTLY.

LOUISIANA'S RESIDENTIAL AND COMMERCIAL USERS ALSO RELY PREDOMINANTLY ON NATURAL GAS.

BECAUSE LOUISIANA IS A CONSUMING STATE AND BECAUSE LOUISIANA'S ECONOMY DEPENDS UPON NATURAL GAS, QUESTIONS RELATING

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[1] THE PROBLEMS WHICH THE NGPA HAS CAUSED FOR LOUISIANA ARE DOCUMENTED IN A STUDY PREPARED BY FOSTER ASSOCIATES, A LEADING INDEPENDENT ENERGY CONSULTING FIRM. THAT STUDY IS ATTACHED TO MY STATEMENT. FOSTER ASSOCIATES CONCLUDED THAT CONSUMERS ARE NOT "SUBSTANTIALLY DISADVANTAGED" BY THE NGPA, AND THEY FOUND THAT THE PROBLEMS FACED BY LOUISIANA WILL GROW MORE SEVERE AFTER 1985 UNLESS THE NGPA IS CHANGED.

TO THE PRICE AND AVAILABILITY OF GAS ARE OF UNUSUAL IMPORTANCE TO LOUISIANA. LOUISIANA -- LIKE THE REST OF THE COUNTRY -- NEEDS A NATIONAL ENERGY POLICY WHICH WILL PRODUCE ADEQUATE SUPPLIES OF GAS AT THE LOWEST POSSIBLE PRICE CONSISTENT WITH THAT OBJECTIVE. THE REGULATORY POLICIES OF THE LAST THIRTY YEARS HAVE NOT MOVED US TOWARD THAT GOAL. THE RIGID PRICE CONTROLS OF THE NATURAL GAS ACT CREATED SHORTAGES, AND THE COMPLEX SCHEME OF REGULATION CREATED BY THE NGPA HAS LEFT A LEGACY OF THREATENED REGIONAL SHORTAGES, MARKET DISTORTIONS, AND PRICES ABOVE THOSE WHICH WOULD PREVAIL IN A FREE, UNREGULATED MARKET. IT IS OUR FIRM CONVICTION THAT ONLY A FREE MARKET FOR NATURAL GAS CAN PROVIDE THE SUPPLIES NEEDED BY THE AMERICAN ECONOMY AT THE LOWEST POSSIBLE PRICES TO CONSUMERS.

WE SUPPORT THE ADMINISTRATION'S PROPOSAL BECAUSE IT PROMISES RELIEF FROM THE PRESENT REGULATORY NIGHTMARE AND BECAUSE IT WILL ACHIEVE OVER TIME, A FREE MARKET FOR NATURAL GAS. THE ADMINISTRATION'S PROPOSAL IS WELL BALANCED, AND IT ADDRESSES THE MOST DIFFICULT PROBLEMS WHICH HAVE ARISEN UNDER THE NGPA. BY REMOVING WELLHEAD PRICE CONTROLS ON JANUARY 1, 1986, WHILE RETAINING CONSUMER PROTECTIONS, IT WILL PERMIT THE MARKET TO MOVE TOWARD DECONTROL IN AN ORDERLY FASHION. WE ALSO SUPPORT THE ADMINISTRATION'S OBJECTIVES TO REMOVE REGULATORY OBSTACLES TO THE FREE MOVEMENT OF GAS. BECAUSE OF ALL THESE EXTREMELY POSITIVE FEATURES IN THE PRESIDENT'S PROPOSAL, WE URGE THE COMMITTEE AND THE CONGRESS TO COMPLETE ACTION ON IT AS QUICKLY AS POSSIBLE.

WHILE WE SUPPORT THE MAIN OBJECTIVES OF THE BILL, THERE ARE A NUMBER OF PROVISIONS WHICH SHOULD BE MODIFIED. SOME OF OUR CONCERNS ARE OF A TECHNICAL NATURE, AND WE WILL COMMUNICATE THEM TO THE COMMITTEE AT A LATER DATE. THERE ARE TWO PROBLEMS WHICH I WOULD LIKE TO MENTION SPECIFICALLY TODAY. THEY ARE: (1) THE STRUCTURE OF THE LIMITATIONS ON PIPELINE PASSTHROUGH OF NEW GAS COSTS; AND (2) THE COMPOSITION OF THE GAS CAP.

1. LIMITATIONS ON PASSTHROUGH.

THE BILL'S LIMITATION ON THE PASSTHROUGH OF GAS PURCHASE COSTS IS MORE RESTRICTIVE THAN NECESSARY, AND IT MAY SERIOUSLY INHIBIT OR DESTROY THE ABILITY OF PIPELINES AND PRODUCERS TO RENEGOTIATE CONTRACTS TO MARKET LEVELS. PIPELINES WHICH NOW ENJOY DEEP CUSHIONS OF LOW COST OLD GAS HAVE LOWER AVERAGE GAS COSTS THAN THE INDUSTRY AS A WHOLE. THEY WILL, ALMOST BY DEFINITION, INCUR PURCHASED GAS COSTS HIGHER THAN THEIR EXISTING AVERAGE COSTS ADJUSTED FOR INFLATION. THEY SHOULD NOT BE REQUIRED TO AWAIT THE COMPLETION OF LENGTHY FERC PROCEEDINGS TO RECOVER PURCHASED GAS COSTS. SECOND, THE STANDARDS WHICH THE FERC IS TO APPLY IN DETERMINING WHETHER TO ALLOW PASSTHROUGH ARE UNCLEAR AND POORLY DEFINED.

THIRD, AND PERHAPS MOST SERIOUS, THE PASSTHROUGH LIMITATION PROVIDES NO MECHANISM FOR PERMITTING PIPELINES TO RECOVER THEIR PURCHASED GAS COSTS, SUBJECT TO REFUND, IF THE FERC REVIEW PROCEEDING IS UNDULY LENGTHY. LOUISIANA HAS PARTICIPATED IN MANY

CONTESTED PROCEEDINGS BEFORE THE FERC, AND WE HAVE LEARNED THAT EVEN EXPEDITED PROCEEDINGS CAN TAKE YEARS TO CONCLUDE IF THEY INVOLVE CONTROVERSIAL ISSUES. IN ALL RATE PROCEEDINGS CONDUCTED UNDER THE NATURAL GAS ACT, THE RISK OF REGULATORY DELAY FOR THE PIPELINES IS MITIGATED BECAUSE THE PIPELINES ARE ALLOWED TO RECOVER THEIR CLAIMED COSTS ON A TEMPORARY BASIS (SUBJECT TO REFUND)[2] WHILE THE FERC COMPLETES ITS PROCEEDING. THE CONSUMER IS FULLY PROTECTED BECAUSE IF, AFTER THE END OF THE PROCEEDING, THE FERC DECIDES THAT THE COSTS CLAIMED BY A PIPELINE WERE UNJUSTIFIED, THE PIPELINE IS REQUIRED TO PAY REFUNDS. SIMILAR PROVISIONS FOR INTERIM COLLECTION OF COSTS, FOLLOWED BY REFUNDS IF THE COSTS ARE FOUND TO BE UNJUSTIFIED, ARE FOUND IN A NUMBER OF OTHER FEDERAL REGULATORY STATUTES, INCLUDING THE FEDERAL POWER ACT, THE INTERSTATE COMMERCE ACT, THE COMMUNICATIONS ACT, AND THE FEDERAL MARITIME ACT. WE URGE THE CONGRESS TO INCLUDE SIMILAR INTERIM COLLECTION AND REFUND PROVISIONS IN THIS LEGISLATION.

2. COMPOSITION OF THE GAS CAP.

PRICES PAID UNDER RENEGOTIATED CONTRACTS SHOULD NOT BE INCLUDED IN CALCULATING THE GAS CAP BECAUSE RENEGOTIATED CONTRACTS WILL NOT NECESSARILY REFLECT THE PRICE WHICH GAS WOULD BRING IN A FREE MARKET. THE RENEGOTIATED CONTRACT PRICE COULD BE EITHER TOO HIGH OR TOO LOW. TO TAKE A COMMON EXAMPLE, A CONTRACT COULD BE

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[2] AFTER A FIVE MONTH DELAY.

RENEGOTIATED TO CHANGE A NON-PRICE PROVISION, SUCH AS A DELIVERY POINT, WHILE LEAVING THE CONTRACT PRICE UNCHANGED. THE CONTRACT PRICE IN THE RENEGOTIATED CONTRACT WOULD NOT REFLECT CURRENT MARKET CONDITIONS. EVEN RENEGOTIATED PRICE PROVISIONS WILL NOT REFLECT CURRENT MARKET CONDITIONS BECAUSE THEY WILL TAKE, AS A BASE OF DEPARTURE, THE PRICE IN THE OLD CONTRACT. THE PRICE OF GAS UNDER AN OLD LOW COST CONTRACT COULD BE RENEGOTIATED TO A LEVEL BETWEEN THE OLD CONTRACT PRICE AND THE MARKET PRICE: SIMILARLY, THE PRICE OF HIGH COST GAS MAY BE RENEGOTIATED TO A LEVEL ABOVE THE MARKET PRICE BUT BELOW THE OLD CONTRACT PRICE. NEITHER OF THESE PRICE CHANGES WOULD ESTABLISH A PRICE WHICH WOULD REFLECT TRUE MARKET CONDITIONS. THE IMPLICATIONS FOR FUTURE SUPPLIES WOULD SEEM OBVIOUS. FURTHER, DUE TO THE PERVERSE IMPACT OF SUCH PRICES UPON THE RELATIVE LEVEL OF THE GAS CAP, AND, IN TURN, THE PRICE TO BE RECEIVED AND PAID FOR OTHER CATEGORIES OF REGULATED GAS, A DISINCENTIVE TO RENEGOTIATION FOLLOWS.

CONCLUSION:

WE EXPECT SHORTLY TO PROVIDE YOU WITH ADDITIONAL RECOMMENDATIONS OF A MORE TECHNICAL NATURE. WE ARE CONCERNED, FOR EXAMPLE, THAT CERTAIN LANGUAGE OF THE BILL AS IT IS NOW DRAFTED COULD BE READ TO PREEMPT THE TRADITIONAL REGULATORY AUTHORITY OF STATE AND LOCAL GOVERNMENTS OVER TRANSACTIONS BY LOCAL DISTRIBUTION COMPANIES AND INTRASTATE PIPELINE COMPANIES. THAT IS OBVIOUSLY NOT THE INTENTION OF THE BILL, AND WE WILL SUGGEST LANGUAGE TO DEAL WITH THE PROBLEM.

IN CLOSING, I WANT TO EMPHASIZE ONCE AGAIN THAT LOUISIANA SUPPORTS THE ADMINISTRATION'S PROPOSAL BECAUSE IT IS A CONSTRUCTIVE AND BALANCED RESPONSE TO THE DIFFICULT PROBLEMS WHICH ARE THE LEGACY OF PAST REGULATORY FAILURE.

The CHAIRMAN Mr. Coleman.

STATEMENT OF LEONARD S. COLEMAN, JR., COMMISSIONER, NEW JERSEY DEPARTMENT OF ENERGY

Mr. COLEMAN. Thank you. Mr. Chairman, distinguished members of the Energy and Natural Resources Committee, I would like to thank you for allowing me to present my views on natural gas decontrol before you today.

I concur with the goals of the administration's bill that responsible actions must be taken to protect consumers and allow free market forces to work. However, I do not agree with some of the approaches and details of the bill. First, let me focus on two areas of concern—the concept of a free market, and the comparison between oil decontrol and gas decontrol.

The administration's bill rests on the theory that the natural gas market can be turned into a free market. I do not believe that the natural gas market is a free market. Decontrol of natural gas wellhead prices does not remove regulations from interstate pipelines or local distribution companies. Distribution companies are limited to purchasing gas from the interstate pipeline companies serving their State.

Consumers, whether they live in Atlantic City, Chicago, or Houston can only purchase gas from one source—their local regulated utility. A market based on price competition with competing fuels such as residual oil in the major industrial gas consuming States does little to help minor consuming States at the end of the pipeline.

In 1981, as Senator Bradley pointed out and I reiterate through my testimony, the 24 States primarily in the northern tier where industrial natural gas prices were within 80 percent of residual oil prices, accounted for less than 10 percent of total natural gas sales in the United States; if 20 percent of this industrial market is lost to fuel switching, producers lose only 2 percent of their load. It is, therefore, unlikely that the prospect of lost markets in these States will influence the price of natural gas at the wellhead.

Proponents of decontrolling all gas, including old gas, have argued that a free market approach will result in lower overall prices. According to testimony delivered by Energy Secretary Hodel before this committee last Wednesday, the price cap under the administration's bill would be approximately $3 per Mcf. Since the current average wellhead price is $2.55 per Mcf, I fail to see how nearly a 20-percent increase in the average wellhead price can result in lower prices for the consumer.

My other area of concern is as I mentioned the inappropriate comparisons being made between oil decontrol and gas decontrol. I will refer to and just allow my paper to stand on that given the time constraints. At this point let me address what I believe is required to ameliorate the present situation.

As I see it, the major problem facing the natural gas market revolves around contracts entered into during a time of severe supply constraints. These contracts are outmoded and inflexible and devoid of any provision for a downward adjustment in price or obligations to reflect market conditions more accurately. If this problem is resolved, the process of decontrol as structured under NGPA will work. Therefore, I have listed in my testimony several recommendations which I would like to put forward before the committee.

Let me just say, Mr. Chairman, before my time is up, I think from the consuming States particularly, I think the very crucial question and one we have to address is the question of cost and or price, and I want to uncategorically state that we feel as though we are opposed in the State of New Jersey to the deregulation of old gas. We feel that it would result in a transfer of wealth from consuming to producing States and that our price structure or rate would rise significantly because of the increased prices in the old gas so that we stand steadfastly against the deregulation of old gas, and as I said, I think from the other points which I have outlined in my paper that the crux of the issue is the question of price, and I let my remarks stand with that.

[The prepared statement of Mr. Coleman follows:]

TESTIMONY OF

LEONARD S. COLEMAN, JR.
COMMISSIONER, NEW JERSEY DEPARTMENT OF ENERGY

BEFORE THE

SENATE ENERGY AND NATURAL RESOURCES COMMITTEE

MARCH 12, 1983

Mr. Chairman, distinguished members of the Energy and Natural Resources Committee, and my fellow panel members, my name is Leonard S. Coleman, Jr., Commissioner of the New Jersey Department of Energy. I would like to thank you for allowing me to present my views on natural gas decontrol before you today. While I represent the State of New Jersey, I believe that my views reflect the national interest.

I concur with the goals of the Administration's Bill that responsible actions must be taken to protect consumers and allow free market forces to work. However, I do not agree with some of the approaches and details of the Bill. First,let me focus on two areas of concern: the concept of a "free market" and the comparison between oil decontrol and gas decontrol.

The Administration's Bill rests on the theory that the natural gas market can be turned into a "free market." I do not believe that the natural gas market is or ever will be a "free market." Decontrol of natural gas wellhead prices does not remove regulations from interstate pipelines or local distribution companies.

Distribution companies are limited to purchasing gas from the interstate pipeline companies serving their state. Gas consumers, whether they live in Atlantic City, Chicago or Houston can only purchase gas from one source . . . their local, regulated utility. They do not have the option of purchasing natural gas from another source in the manner that oil consumers do. Residential and commercial gas customers are essentially "captive," able to switch fuels only when a decision has been made to purchase and install new equipment at considerable capital costs. Only the industrial market, where dual-fuel capability has become the norm, is there competition between the fuels.

A market based on price competition with competing fuels, such as residual oil, in the major industrial natural gas consuming states does little to help minor consuming states at the end of the pipeline. In 1981, the 24 states, primarily in the Northern tier, where industrial natural gas prices were within 80% of residual oil prices, accounted for less than 10% of total natural gas sales in the United States. If 20% of this industrial market is lost to fuel switching, producers lose only 2% of their load. It is therefore unlikely that the prospect of lost markets in these states will influence the price of natural gas at the wellhead.

Proponents of decontrolling all gas, including "old" gas, have argued that a free market approach will result in lower overall prices. According to testimony delivered by Energy Secretary Hodel before this committee last Wednesday, the price cap under the Administration's Bill would be approximately $3.00 per Mcf. Since the current average wellhead price is $2.55 per Mcf, I fail to see how a nearly 20% increase in the average wellhead price can result in lower prices for the consumer.

As for a windfall profits tax to cushion the impact of these price increases, I have several concerns: First, as the history of the Oil Windfall Profits Tax demonstrates, consumers do not receive the full return to which they are entitled. The Oil Act requires 25% of all annual receipts be set aside to assist the poor in payment of energy bills. In 1982, the 25% amounted to $4.6 billion, but only $1.9 billion was appropriated for this purpose. Second, the economic hardship will be severe on more than our low income and elderly population. Middle income Americans are also confronted with economic hardship, and they will not realize relief from such windfall profits tax schemes. Third, the establishment of a mechanism or bureaucracy to achieve such a redistribution of taxes would be costly. If we are collecting windfalls from producers to give to the consumers paying the higher prices, why don't we just leave the money in the hands of the consumers who need it?

My other area of concern centers on the inappropriate comparisons being made between oil decontrol and gas decontrol. At the time of crude oil decontrol, approximately 75% of domestic supply was already decontrolled. In the natural gas market, less than 10% of supply is presently free of price controls. Additionally, crude oil competes in a world market, whereas natural gas competes primarily in the domestic market. The problems of transporting and storing natural gas point out that gas is a resource quite different from crude oil. Therefore, any analysis that compares the two fuels as substitutes for one another does not recognize the complexities and subtleties of each market.

At this point let me address what I believe is required to ameliorate the present situation.

There is wide agreement that the Natural Gas Policy Act has not entirely achieved its desired results and requires modification. When you have a system in place, and you can identify the flaws, the prudent and responsible action is to correct the flaws, not jettison the entire system.

As I see it, the major problem facing the natural gas market revolves around contracts entered into during a time of severe supply constraints. These contracts are outmoded and inflexible and devoid of any provision for a downward adjustment in price or obligations to reflect market conditions more accurately. If this problem is resolved, the process of decontrol as structured under NGPA will work. Therefore, I recommend that the following modifications be made to the NGPA in order to accomplish the stated goals:

1. The Administration's plans to limit price increases through contract renegotiation and price caps are a move in the right direction, but a more direct - and we believe a more effective - way to address the problem is to eliminate indefinite price escalator, favored-nation, and area rate clauses in all contracts.

2. The Administration's plan to treat any contract which includes natural gas in more than one price category as separate contracts for each category should be adopted. Many contracts currently specify a total volume which is the sum of two or more volumes from different NGPA categories. This has created problems when take-or-pay provisions are reduced without requiring proportionate reductions in the higher cost volumes as well as the lower cost volumes.

3. The Administration's proposal to allow a one-time permanent reduction to 70% of take-or-pay requirement is unacceptable. We would support a moratorium (possibly 3 years) on take-or-pay clauses limiting them to a reasonable percentage (50-70%) while maintaining the purchaser's future right to all contracted volumes.

4. The Administration's proposal to limit guaranteed pass-through of purchased gas costs can be accomplished more directly by amending FERC's existing authority to require interstate pipelines to justify that their gas acquisition costs are reasonable, prudent and responsive to their markets.

5. The Administration's plan to repeal the Fuel Use Act and incremental pricing provisions is acceptable.

Additionally, I believe that there are certain sections of the NGPA which must not be modified. In order to assure adequate natural gas supplies at a reasonable price, the modified NGPA should retain two key elements.

First, it should retain controls on the price of "old" gas. Decontrol of "old" gas would result in a transfer of wealth from consuming to producing states since it only increases the value of gas supplies already under production. Since producers would get the same price for "old" gas as they would for newly discovered gas, and because production costs are less for "old" gas, producers would have little incentive to increase expenditures for exploration. However, I would support price incentives to increase "old" gas supplies above current recoverable volumes. These price incentives should be determined by FERC based upon a recognition of the current real cost of bringing on the added reserves.

Second, NGPA should retain dedication of reserves of natural gas to interstate pipelines, the development of which was financed by interstate pipeline customers. Coupled with the retention of price controls on "old" gas, the dedication of significant quantities of "old" gas to interstates allows them to cushion the impact of the higher cost of deregulated gas they purchase. Rather than provide the interstates with an unfair competitive advantage, dedication of these categories of "old" gas acts to narrow the difference between interstate and intrastate prices.

These recommendations are discussed in further detail in the paper, "Natural Gas: Issues and Options for New Jersey", which I have appended to my testimony. This paper, which was prepared by the New Jersey Department of Energy, offers a comprehensive examination of various decontrol strategies and contract issues. It provides a clear understanding of the role of natural gas in New Jersey's overall fuel mix, and assesses the impact on New Jersey of natural gas issues and pricing strategies on the national level.

New Jersey and, for that matter, the entire Northeast, needs natural gas. Natural gas use is important to us in terms of improved air quality, decreased dependence on foreign oil and a more diversified fuel mix. Total decontrol will result in the replacement of gas by oil in this region, a result that is contrary to the national interest in both strategic security terms and economic balance of payment terms.

In conclusion, I want to re-emphasize the point that the Administration and the State of New Jersey share the same goal, namely, providing all natural gas consumers with adequate supplies at a fair and reasonable price. Although we may differ on the means of reaching this end, we must not allow those differences to interfere with the need for all of us to work together towards an equitable solution. To do otherwise -- or to do nothing at this point but continue the status quo -- does a disservice to the constituents and interests we serve.

I envision the plan I have set forth here today not as the parochial viewpoint of a consuming state or region, but rather as a proposal that is in the best interests of the entire country. My Department stands ready to assist the members of this committee and its staff in working towards a fair solution to this issue.

Thank you again for giving me this opportunity to appear before you.

NATURAL GAS:
ISSUES AND OPTIONS FOR NEW JERSEY
JANUARY 28, 1983

Natural gas has become the focus of an ongoing national debate on energy policy. Natural gas is regulated by the Federal Energy Regulatory Commission (FERC) through the Natural Gas Policy Act of 1978 (NGPA). Its passage was marked by acrimonious debate, and its policies represent a compromise of various positions held by producers, distributors, end-users and regulators. Since the complete decontrol of crude oil in January of 1981, there has been increased pressure from various parties to decontrol natural gas as well.

The natural gas market is currently in a state of flux as it reacts to regulatory prerogatives, market conditions, contractual obligations and competing fuels. The concerns of a year ago, and even a few months ago, have been replaced by newly emerging issues. Whereas the NGPA was conceived in a time of supply constraints, we are now facing a demand/pricing (marketing) problem as economic stagnation has resulted in declining industrial use, conservation in all sectors and fuel switching in the industrial sector. New strategies and positions regarding supplies and marketing are being proposed on a regular basis as part of the dynamic, changing nature of the natural gas market.

New Jersey has been adversely affected by marketing problems which have arisen as a result of implementing the NGPA. Thus, the New Jersey Department of Energy (NJDOE) has undertaken this study with two objectives:

1. To assess how New Jersey, given the role of natural gas in its overall fuel mix, will be affected by various natural gas issues and pricing strategies at the national level; and

2. To determine what options are available to New Jersey to minimize natural gas price increases and to mitigate the economic impacts associated with those increases.

FINDINGS

The continuing process of natural gas decontrol will have a marked effect upon New Jersey customers. Under the NGPA, NJDOE estimates that:

- The real cost of natural gas will increase at an average rate of 8.5% per year from 1983 to 1990[1]. A typical residential heating customer (1,400 therms per year for space heating, water heating, cooking and clothes drying) who paid $647 in 1980, will pay an average of $1,492 (in 1980 dollars) annually for this period.

There will be little difference in this average annual cost if decontrol was accelerated to 1983 or if controls were extended to 1987 but a significant difference if total decontrol (including "old" gas) was instituted in 1983. For the period of 1983 to 1990, NJDOE estimates that the real annual average cost for this typical residential heating customer will be:

- $1,535 (in 1980 dollars), or approximately three (3) percent higher with accelerated decontrol than under NGPA
- $1,478 (in 1980 dollars), or approximately one (1) percent lower with extended controls, and
- $1,615 (in 1980 dollars), or approximately eight (8) percent higher with total decontrol.

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[1] This estimate is based upon the assumption that natural gas prices will reach parity with residual fuel oil.

Both the increasing price of natural gas and the relative lack of difference over time of the effect of the decontrol strategies result from rapidly dwindling amounts of low cost "old" gas available to the interstate pipelines serving New Jersey.

There are, however, a number of issues on both the national and State level which, if addressed properly, could reduce the burden of price increases to New Jersey consumers. Primary among these are indefinite price escalator and take-or-pay clauses in contracts between natural gas producers and interstate pipelines because these have the greatest direct impact on prices. If these issues were resolved, it would provide an impetus to resolve the remaining issues. If the natural gas decontrol process continues as scheduled under NGPA without any action taken to resolve the contract issues, NJDOE estimates that:

- The real total marginal cost to New Jersey consumers, which will result solely from the effect of those contract issues, will be over $100 million (in 1980 dollars) in 1985.
- The real total marginal cost to the typical residential space heating customer will be $45 (in 1980 dollars) in 1985.

The burden of this increase will fall most heavily on New Jersey residents as their direct costs increase and as the other consuming sectors pass through their increased costs. This occurs because the residential market cannot readily switch from gas to alternative fuels, and has no market to which it can pass along greater costs. The industrial and commercial markets have the ability to pass along increased costs to purchasers of their products and services. The residential market will also bear a greater proportion of the fixed costs of the transportation and distribution system as some industrial users drop off the system.

As evidenced by these findings, the timing of decontrol has less impact on the cost to consumers in New Jersey than does the resolution of the contract issues. Therefore:

- From the viewpoint that interstate pipeline companies are passing on their increased prices due to take-or-pay and indefinite price escalator clauses in their contracts, the State supports the present plan of decontrol where controls are gradually phased out. The remaining two years of the decontrol process will allow sufficient time for these clauses to be modified through negotiation or legislation so that they more accurately reflect market conditions. If the contract issues were resolved immediately, the accelerated decontrol option would be endorsed. However, if these issues are not resolved, the extended controls option would be favored.
- The State opposes total decontrol of natural gas, including "old gas", since it would result in a windfall for the producers and possibly the Federal government if a windfall profits tax is enacted. For the years that "old gas" supplies remain, the interstates will be able to roll-in the costs of this gas with their new gas purchases, minimizing the price increases from New Jersey's major interstate suppliers: Transcontinental Gas Pipe Line Corporation (Transco), Texas Eastern Transmission Corporation (Texas Eastern) and Tennessee Gas Pipeline Company (Tennessee).

PRESENT CONDITIONS

National Picture

The price of natural gas to the end user in New Jersey is largely determined by regulatory actions at the federal level.

- The price spike that was supposed to occur at the time of deregulation in 1985 has occurred already. The importance of decontrol initiatives, therefore, are centered primarily on regulatory/legal issues as related to contracts rather than the actual timing of decontrol.
- Prices on "new" natural gas and decontrolled gas have begun to moderate as interstate pipelines have had difficulties in marketing their gas. In reaction to market conditions, a growing number of interstate pipelines are exercising market-out clauses on high priced gas and attempting to renegotiate existing contracts which do not include such options.
- Since the industrial market is sensitive to relative fuel prices where dual-fuel burning capability exists, fuel switching from gas to oil is occurring.
- Contract issues between producers and pipeline companies are the most pervasive and significant of all the problems facing the natural gas industry. Contracts, which were signed in times of supply constraint, are outmoded and inflexible due to the inclusion of clauses (e.g., indefinite pricing provisions, favored nation clauses) which cause inefficient extraction and distribution of natural gas. Any decontrol initiative must address these contract issues.

The Purchased Gas Adjustment (PGA), under Section 601 (c) of the NGPA, allows a guaranteed passthrough of the cost of purchased gas except to the extent when FERC "determines that the amount paid was excessive due to fraud, abuse, or similar grounds". FERC's interpretation of fraud and abuse reduces incentives for keeping gas acquisition costs low. In a recent decision, however, a FERC Administrative Law Judge ruled that FERC's past policy on PGAs was too narrowly drawn and should be largely disregarded. He further ruled that an interstate pipeline company had been guilty of "abuse" because it had bought excessive quantities of high-priced gas while reducing purchases of the cheaper gas available to it.

Experience in the marketplace indicates that the price of crude oil and its refined products is the controlling factor in the pricing of alternative energy sources. Moderating crude oil prices will ultimately limit the ability of natural gas producers to increase their prices. Price increases for natural gas, therefore, are expected to moderate in the future barring international disruptions of oil supplies.

The increased importation of natural gas from Canada and Mexico is being considered. Regulatory proceedings are focusing on the proper pricing and contract terms for various proposed importation projects.

FERC has found it necessary to conduct numerous inquiries because it failed to exercise its statutory power to require the filing of pertinent information.

New Jersey Picture

New Jersey is at a distinct disadvantage because it is not a gas producing state. More importantly, New Jersey is essentially at "the end of the pipeline", resulting in higher transportation costs being added to the actual cost of the gas.

New Jersey's gas use profile is significantly different from the national profile. As shown below, New Jersey's residential gas market share in 1980 was 40.2%, while the residential market constitutes only 26.1% in the U.S. profile. In contrast, the industrial sector represents the largest market for gas in the United States (39.4%), while it accounts for a much smaller share (18.5%) in New Jersey.

Comparison of Natural Gas Market Shares
1980

Sector	NJ	US
Residential	40.2%	26.1%
Commercial	17.6%	13.4%
Industrial	18.5%	39.4%
Electric Utility	23.4%	20.2%

Source: Natural Gas Annual 1980, Energy Information Administration, Office of Oil and Gas, US Department of Energy, February 1982, pp.30, 31

Natural gas is primarily supplied to New Jersey by five interstate natural gas pipeline companies, of which two, Transco and Texas Eastern, provide the State with approximately 55% and 28% respectively. As a result, the future pricing of natural gas in New Jersey will largely be tied to the rates charged by these two companies.

Transco's average system cost of natural gas is among the highest in the nation. Because of previous supply constraints, Transco entered into contracts with high take-or-pay requirements and high acquisition costs. Transco is experiencing marketing problems because its high gas costs have led industrial users with dual-fuel capability to switch to competitively priced No. 6 (residual) fuel oil.

The Gross Receipts and Franchise Tax adversely affects the marketing of natural gas in the State and increases the price to the end user. Fuel oil is not taxed in the same manner and thus has an inherent competitive edge. Although fuel oil dealers pay real estate taxes to municipalities, the revenues generated by these taxes do not approach those generated by the Gross Receipts Tax.

The use of natural gas in the industrial and electric utility sectors plays an important role in meeting the air quality standards of the State. As the price of natural gas rises, fuel switching may occur. This would result in increased air pollution which could limit the expansion of existing industrial facilities or the siting of new ones.

- There are a number of proposals to import natural gas from Canada either by interstates serving New Jersey or by consortiums that include New Jersey gas utilities. The economic viability of each proposal, however, will be affected by the border price and contractual clauses which are under review by Canada's National Energy Board (NEB).
- Questions have been raised as to the reasonableness of meeting peak demand through gas storage. These questions focus on two major areas: the cost-effectiveness of gas storage and the location of gas storage facilities.

CONCLUSIONS AND RECOMMENDATIONS

National Issues

In 1985 over 90% of natural gas supplies to be decontrolled will be subject to indefinite price escalator clauses. Unless this and other contract issues are resolved, there could be a difficult period of transition under present regulations that would cause short-term (and possibly long-term) disruptions in the market. Thus, addressing the contract issues is of paramount importance in affecting a smooth transition from a regulated to a deregulated market. It is therefore recommended that:

- The State work with its Congressional Delegation in evaluating and proposing legislation dealing with those clauses in existing contracts which are detrimental to the State's ratepayers. Such legislation should include provisions which modify price escalation clauses, mandate the inclusion of market-out clauses and address take-or-pay provisions.

The State work with its Congressional Delegation to provide a mandate for FERC which would ensure that all future contracts contain market-out clauses and, to the maximum extent possible, limit price escalation and take-or-pay clauses.

- The State intervene in FERC proceedings to argue for policies regarding existing contracts to prevent the implementation of excessive price escalator and take-or-pay clauses, and to encourage the renegotiation of contracts to include market-out clauses.
- The State intervene in FERC ratemaking and PGA proceedings to ensure that contracts contain market-out clauses and, to the maximum extent possible, limit price escalation and take-or-pay clauses.
- In order to facilitate the above actions, the State should require that interstate pipelines file all contracts and other pertinent information on a timely basis with NJDOE.

Under the present schedule of deregulation, "old gas" will remain under price controls. Producers of old gas have argued that, from the viewpoint of economic efficiency, there are few incentives to maintain existing old gas flows. If old gas production could be maximized, the demand for higher priced gas could be offset. Thus, it is recommended that:

- New Jersey's Congressional Delegation act to ensure that any legislation dealing with natural gas decontrol retain price controls on "old gas". Price incentives to maintain or increase "old gas" production should be examined.

Natural gas from the outercontinental shelf, Section 102(c,d), is presently dedicated to interstate commerce. Additionally, Section 104 gas is dedicated to interstate commerce. Intrastate pipelines have argued that they should have access to the dedicated gas as well. Intrastates, however, have lower transportation costs and can therefore bid higher for gas without adversely affecting its marketability. Hence, it is recommended that:

. New Jersey's Congressional Delegation act to ensure that any legislation dealing with natural gas decontrol retain dedication of gas to the interstate market. Interstate gas should be made available to intrastates only after a thorough review by FERC and for limited time periods only. Interstates and their customers have paid for the development of the infrastructure to produce and transport such gas and should retain the benefits where at all possible.

Pipeline companies have been allowed to pass through increased gas acquisition costs to their customers in their PGA filings. They have not had the proper incentive to "shop around" for the lowest priced gas supplies. FERC acknowledged the significance of this issue in October of 1982 when it outlined a new approach featuring an incentive rate design for pipelines. Therefore, it is recommended that:

. The rate of return allowed to interstate pipelines reflect their success in minimizing purchased gas costs. Pipelines which are successful in this respect would be rewarded with a higher rate of return.

Interstate pipeline companies justify to FERC that the increased gas costs presented in their PGA filings are reasonable as well as responsive to their markets. Therefore, FERC would provide management of pipeline companies with an incentive to search for the lowest priced gas supplies since PGA costs would not automatically be passed on to the pipeline companies' customers.

- The State intervene in FERC ratemaking and PGA proceedings to argue for the above policies.

Interstate pipeline companies are continually searching for new sources of natural gas to supplement their gas supply to meet future customer demand. In the Northeast and New Jersey in particular, the reliability of Canada as a supplier of natural gas is being evaluated by the United States Department of Energy. Various importation proposals could be economically viable due to shorter transportation distances (and thus lower costs).

- The State should become actively involved in FERC proceedings and support Canadian gas import proposals where New Jersey would receive increased supplies of natural gas at a competitive price and under favorable contract terms.

New Jersey

As the decontrol of natural gas proceeds according to the NGPA schedule, the natural gas industry will have increased difficulty retaining the industrial gas market because of the pipeline companies' difficulty in maintaining competitive burner tip prices. The loss of large volume industrial users will result in a shift of the financial burden to other gas consumers. The demand constancy of large volume industrial users not only allows the pipeline to operate more efficiently but also to distribute its operating costs over a larger volume of sales, spread evenly over the year. As such, the loss of the industrial market disrupts this balance, increases a pipeline system's weather sensitivity and forces operating cost recovery onto remaining users with a resultant increase in the delivered price of gas.

With the continued increase in gas prices, the demand of industrial markets for natural gas will shrink. Therefore, the shifting of industrial markets to fuel oil will cause residential and commercial customers to bear a larger share of the fixed system costs. It is therefore recommended that:

- The State intervene in Board of Public Utilities (BPU) ratemaking proceedings to argue for a flexible industrial sector tariff rate, which would be subject to periodic adjustments to meet residual fuel oil competition. By allowing gas to compete more effectively in the industrial market, higher volumes would flow through the pipeline system, benefiting all customers.

- The State undertake a comprehensive survey of the industrial sector, its fuel use and capability to fuel switch in order to facilitate long-term energy planning in conjunction with the implementation of the Energy Master Plan.

The Gross Receipts and Franchise Tax (approximately 14%) was conceived with the intent of compensating municipalities for the siting of utility facilities within their communities. Spurred by falling tax revenues attributed to the current recession as well as reductions in federal funding, the State and municipalities have been facing serious budget deficits, and as a result, have become increasingly reliant on the Gross Receipts Tax revenues to alleviate their fiscal problems. State utilization of a portion of the municipal share of Gross Receipts Tax revenues has prompted lawsuits and increased resistance from municipalities. The Legislature is examining numerous proposals to resolve this conflict.

These proposals focus on the allocation of revenues collected and ignore the question of the equity of the tax. Fuel oil, the main fuel competing with natural gas, has no comparable tax. Although fuel oil dealers pay real estate taxes on their facilities to local governments, these taxes do not fluctuate with changes in the price of oil. As a result, the Gross Receipts Tax puts natural gas at a competitive disadvantage and causes the consumer to pay an increased price for gas. Additionally, the industrial and electric utility sectors which are the most sensitive to price increases, could be driven to fuel switch as a result of the inflationary effect of the tax, thus raising costs to the remaining gas customers. With the rapidly escalating natural gas prices, tax revenues have risen based solely on the increased price of the gas.

For example from 1980 to 1981, consumption in the residential heating sector increased approximately 2% while the Gross Receipts Tax paid by that sector increased nearly 25%. Therefore, it is recommended that:

- The legislative review of the Gross Receipts and Franchise Tax include the examination of the equity issue as well as the allocation of revenues.
- The State utilize the Gross Receipts and Franchise Tax as an energy policy tool as well as a revenue generator. The collection of revenues might be based on a BTU tax for all major energy sources.

Transco and Texas Eastern supply the State with over 80% of its gas. Additionally, one distribution company receives over 95% of its gas from Transco, while another receives over 80% of its gas from Texas Eastern. Thus, the State is in a precarious position with regard to gas pricing and supply. There is no "quick fix" to this situation but medium and long-term goals should be established to alleviate it. It is therefore recommended that:

- The State formulate a policy to have gas distributors diversify their suppliers while maintaining least-cost gas purchasing practices. The policy should establish a review procedure when company purchases from one supplier exceed an adopted threshold level.
- The State study the benefits of gas distribution companies' independent exploration/production subsidiaries as well as the formation of consortiums as a means of diversifying the companies' gas supply.

- The State request FERC to convene a hearing to investigate the strategy of gas distribution companies purchasing gas at the well head and then negotiating with an interstate pipeline company to transport the gas to their service areas.

Storage of natural gas during non-peak demand periods (April - September) for peak demand periods has been the normal manner of operation for the natural gas industry. With increasing energy prices, the cost of storage has come under scrutiny. Gas is stored out-of-state in underground and liquefied natural gas (LNG) facilities, and in-state in LNG facilities only. By increasing the efficiency of existing natural gas use in the State and through load management, the peaks of consumption can be moderated resulting not only in direct savings but also in indirect savings through reduced storage costs. It is therefore recommended that:

- The State initiate a review of gas storage operations to determine how such operations affect gas costs and options for minimizing such costs.
- The State review the gas distribution companies' peak demands, explore options, formulate and implement a policy to meet and/or reduce those demands. This would include a review of proposals to expand or construct LNG or underground storage facilities.
- The State promulgate rules and regulations to facilitate the review of in-state oil and gas exploratory drilling and storage operations.

One of the major difficulties encountered in conducting an inquiry into natural gas pricing and supply has been the lack of data upon which an analysis could be conducted. Critical information, especially the information pertaining to natural gas purchase contracts, is not available. It is therefore recommended that:

- The State require distribution companies to file a copy of all gas purchase contracts and other pertinent information with NJDOE.

On such critical issues there has been a lack of a forum for State officials to address the marketing and purchasing practices of interstates and distributors. As a result, it is recommended that:

- NJDOE hold meetings with the New Jersey Congressional Delegation to keep it apprised of the State's concerns and to offer assistance regarding the analysis of energy issues and the development of congressional initiatives.
- NJDOE hold informational meetings on a regular basis with the interstates serving New Jersey and with the distribution companies operating in the State.

Abbreviations

Btu	British thermal unit
FERC	Federal Energy Regulatory Commission
LNG	Liquified Natural Gas
MMBtu	One (1) million Btus
NEB	Canadian National Energy Board
NGPA	Natural Gas Policy Act of 1978

GLOSSARY

British Thermal Unit - The amount of thermal energy required to raise the temperature of one (1) pound of water one (1) degree Fahrenheit at atmospheric pressure from 59.5°F to 60.5°F.

Burner Tip Prices - Price of fuel as paid by the end-user or consumer of the fuel. This price would include well-head, transportation and distribution costs, as well as profits and any taxes in the cost of the fuel.

Gross Receipts and Franchise Tax - There are four different taxes imposed on the gross receipts of certain public utilities in New Jersey. Each electric, gas, water and sewer company, as well as other public utilities in general are subject to the following taxes based on gross revenues: 1) franchise tax for the privilege of exercising its franchises and using the public streets, highways, roads or other public places in the State of New Jersey, 2) gross receipts tax in lieu of all State, county, school and local taxation of personal property, 3) excise tax on public utilities for State use imposed on the gross receipts of the utility as prescribed for the franchise tax and 4) an excise tax on public utilities for State use imposed upon the gross receipts of the utility for the preceding calendar year. In New Jersey, the gross receipts and franchise tax amounts to approximately 14% on all bills for electricity, gas or water services provided by a public utility.

Liquefied Natural Gas (LNG) - Natural gas that has been cooled to about minus 260 degrees centigrade for shipment or storage as a liquid. Liquefaction greatly reduces the volume of gas, thus the cost of shipment and storage of gas.

Market-out Option	-	An option that is included in a contract that allows the purchaser to withdraw from the contract if the purchaser cannot market the gas at the prices specified in the contract.
MMBtu	-	An abbreviation for one million British thermal units for petroleum and gas applications which reflects the energy or heating value.
NGPA	-	Enacted in 1978, the Act granted FERC jurisdictional authority over virtually all natural gas transactions intrastate as well as interstate. The Act created various gas categories and associated maximum prices tied to physical characteristics of a well such as proximity to other wells, date of market contracts for production, the date gas production began, and whether or not the gas produced was sold to interstate markets on or before November 8, 1976.

The CHAIRMAN. Thank you very much, Mr. Coleman. Mr. O'Connor?

STATEMENT OF PHILIP R. O'CONNOR, CHAIRMAN, ILLINOIS COMMERCE COMMISSION

Mr. O'CONNOR. Thank you, Mr. Chairman and members of the committee. My name is Philip O'Connor, and I am chairman of the Illinois Commerce Commission which is the public utility regulator in the State of Illinois.

We need to answer the basic question of why, when there is an oversupply of gas, price continues to escalate, and we need a program to solve that basic, fundamental problem.

We are urging Members of the Senate and the House and the policymakers of the administration to deal with that simple problem by adopting what we have termed the consumer access plan as a common and compatible element of all the natural gas legislative proposals that are coming before the Congress.

Additionally, the consumer access plan which has been distributed to you has merits as legislation by itself and this plan, developed at the Illinois Commerce Commission, will have an immediate and significant downward effect on the average price of natural gas paid by consumers in this country.

On the day this consumer access plan would become law, valves would be turned within the natural gas industry to lower some consumer gas bills by 25 percent. All consumers would benefit to some degree because the consumer access plan will stimulate contract renegotiation on current committed gas supply that will act directly to ratchet the price of new natural gas downward.

The consumer access plan is not predicated on piling regulation on regulation or on some phased withdrawal of regulation. It is not based on substituting the judgment of bureaucrats like me for the market. It is an effort to cut the Gordian knot by promptly eliminating the single most anticompetitive link in our natural gas supply system.

The sum and substance of the plan is the pipelines should be immediately changed to the status of common carriers. For the benefit of their end use customers, gas utilities should be allowed and in fact encouraged to do what is done throughout our economy and go directly to producers, purchase available supplies, and pay a reasonable fee for transportation. Distributors, of course, will be free to continue to purchase from their existing pipeline suppliers, but that would be their choice.

There is simply no longer any justification for maintaining monopoly status for pipelines, shared or exclusive, in their relationship with producers and utilities.

The much-criticized Natural Gas Policy Act, as we all recognize, has induced substantial increases in natural gas supply and has lessened the total demand for natural gas. However, because of excessive rigidity and a general lack of competitive pressures, natural gas prices under NGPA have risen more on average than was necessary. Consumers could have enjoyed the same abundance of new gas supplies at much lower prices.

The plan that we have submitted to the committee and are urging other Members of the Congress to look at is an eight point plan that is summarized in the prepared statement that we have provided to you.

Let me emphasize that I would imagine that in the past 3 days and today we have heard a lot of people chant the monologue of competition before this committee. Unfortunately, if you look at all the proposals before you, none of them take the fully serious steps needed to get to a competitive marketplace. Simply decontrolling wellhead prices won't do it. You have got to do what you do in every other sector of our economy, and that is give buyers access to sellers.

The current system doesn't do that, and virtually everybody that has come before this committee I believe has basically said that. Unless you restructure that fundamental structural characteristic, then we are probably all going to be back here next year after suffering a much worse situation than we have this winter.

The Illinois Commerce Commission is committed to working with the Senate, the House, and the administration in the effort to reach a genuine resolution of the natural gas pricing system this year.

Thank you, Mr. Chairman.

[The prepared statement of Mr. O'Connor follows:]

STATEMENT OF PHILIP R. O'CONNOR

CHAIRMAN

ILLINOIS COMMERCE COMMISSION

Thank you Mr. Chairman and members of the Energy and Natural Resources Committee for this opportunity to appear. My name is Philip R. O'Connor. I am Chairman of the Illinois Commerce Commission, which is the agency charged with the regulation of electric, telephone, and natural gas utilities in Illinois.

INTRODUCTION

We are urging the members of the Senate and the House and the policymakers in the Administration to adopt the Consumer Access Plan as a common and compatible element of all the natural gas legislative proposals that have come before this Committee. Additionally, the Consumer Access Plan has merits as legislation by itself. This plan, developed at the Illinois Commerce Commssion, will have an immediate and significant downward effect on the average price of natural gas paid by consumers. On the day this Consumer Access Plan is passed, valves would be turned within the natural gas industry that would lower some consumer gas bills by 25%. All consumers will benefit to some degree because the Consumer Access Plan will stimulate contract renegotiation on current committed gas supply that will act to ratchet the price of new natural gas downward.

The Consumer Access Plan is not predicated on piling regulation upon regulation or on some phased withdrawal of regulation. It is an effort to cut the Gordian knot by promptly eliminating the single most anti-competitive link in our natural gas supply system.

Pipelines should be immediately changed to the status of common carriers. They should be taken out of their anomolous and, I should note, unique position in our economy of being the sole owners of the commodity while in transit.

For the benefit of their end use customers, utilities should be allowed to do what is done throughout our economy and go directly to producers, purchase available supplies and pay a reasonable fee for transportation. Distributors would be free to continue to purchase from their existing pipeline supplier(s); that should be their choice.

There is simply no longer any justification for maintaining monopoly status for the pipelines, shared or exclusive, in their relationship with producers and utilities.

In the United States a large amount of new domestic natural gas is being shut in. Most producers have decreased their drilling activity because they can't find pipeline purchasers. In the downstream markets, industries in Illinois are shutting down to convert to alternative fuels due to the high price of natural gas. Yet, producers are willing to produce and explore at a price for natural gas plus transportation that is below the cost of alternative fuels. The pipeline is sitting in the middle and refusing to carry lower cost gas on reasonable and non-discriminatory terms; the pipeline is sitting in the middle with commitments to a very expensive gas supply that need be renegotiated or terminated.

The much criticized Natural Gas Policy Act has induced substantial increases in natural gas supply and has lessened the total demand for natural gas. However, because of excessive rigidity and a general lack of competitive pressures, natural gas prices under the NGPA have risen more on average than was necessary. Consumers could have enjoyed the same abundance of new gas supplies at much lower prices.

THE CONSUMER ACCESS PLAN

The Illinois Commerce Commission believes that sufficient competition to ensure lower prices for all consumers can be achieved only through strong consumer access legislation which thoroughly restructures natural gas pipeline regulation.

The Consumer Access Plan includes the following provisions.

1. Immediately change natural gas interstate pipeline status to common carriage.

2. Declare null and void all existing pipeline-distributor contracts including "sole supplier/minimum bill" clauses, thus permitting distributors to secure low cost gas supplies for their customers.

3. Eliminate all current pipeline obligations to purchase gas for distributors. Pipelines should be permitted to "market out" on contracts with producers for any load loss which results from common carriage.

4. Authorize FERC to establish new common carrier obligations and transportation/storage tariffs for pipelines. The distributor would pay the pipeline for actual transportation costs incurred at the tariffed rate.

5. Direct the U.S. Department of Justice to report to Congress on the adequacy of competition under existing pipeline vertical integration.

6. Declare all new gas and gas not under contract as "free access gas" which may be purchased by distributors and transported under tariff by pipelines.

7. Require that by 1/1/1985, for any gas contracts not renegotiated, either party may exercise "market out" rights and dissolve contract obligations.

8. Authorize FERC to require pipeline interconnections and system extensions upon a demonstration of public convenience and necessity.

Under the Consumer Access Plan, responsibility for gas purchase decisions will be closer to ultimate consumers with oversight by state public utility commissions who will be responsive to state and local concerns. Producers should support this change in pipeline status as eagerly as consumers because it will expand their markets for gas sales. And many pipelines will recognize that the Consumer Access Plan gives them an opportunity to focus on their primary function: the transportation of natural gas while achieving a fair rate of return on their investment.

The Consumer Access Plan provides for the renegotiation of pipeline-producer contracts on a phased-in basis which parallels the time schedule in the Administration's proposal. Many existing contracts now held by pipelines are already unenforceable because pipelines will be unable to market the quantities of gas to which they are committed at current prices. Remaining contracts should be renegotiated by 1/1/86 so that pipelines do not institutionalize further these harmful prices distortions.

Common carriage is a well-understood and useful regulatory framework which is now serving the public well, particularly in the case of oil pipelines. The solution proposed here is not a unique one. Rather, it is the current regulatory license now afforded to gas pipelines which is inappropriate and without precedent in this country's regulatory history.

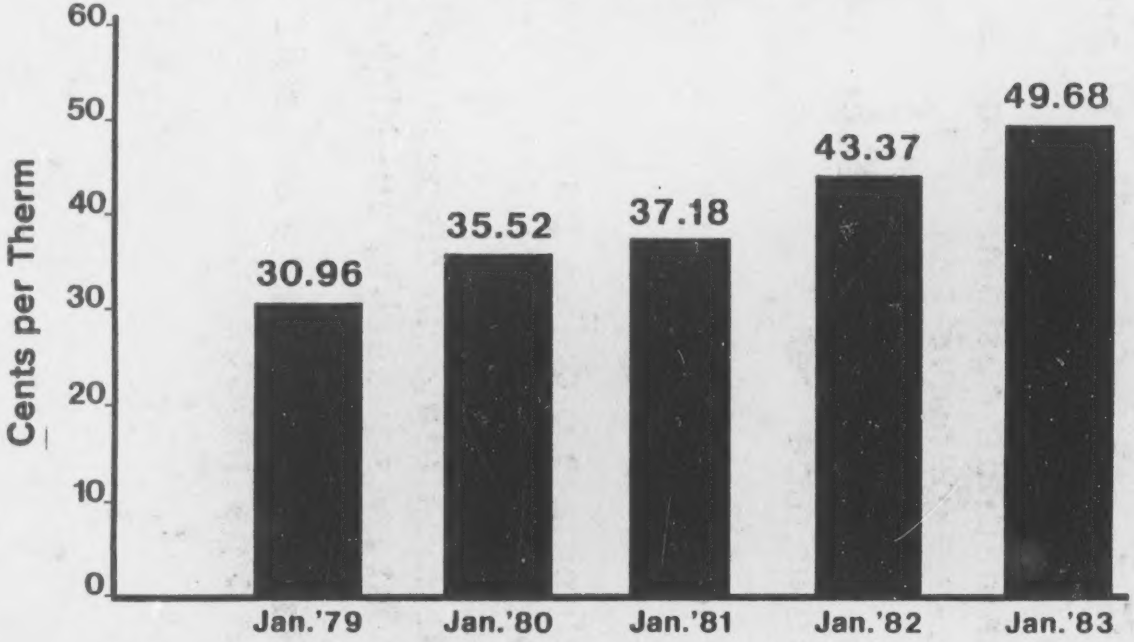
Overall, the Consumer Access Plan will guarantee immediate customer access to less expensive gas, ensure customer access to other pipelines, force pipelines to be more responsive to market forces, eliminate pipeline market power over producers and customers, reduce regional disparities in gas prices by squeezing out high cost gas, move gas purchase decisions from pipelines to distributors and large end users, and eliminate waste in the interstate pipeline system.

Effects of Illinois Plan

- Immediate customer access to less expensive gas.
- Immediate customer access to other pipelines.
- Force pipelines to be responsive to market forces.
- Eliminate pipeline power over producers & customers.
- Reduce regional disparities in gas cost by squeezing out high cost gas.
- Squeeze out waste & inefficiency in pipeline operations.

Peoples Gas

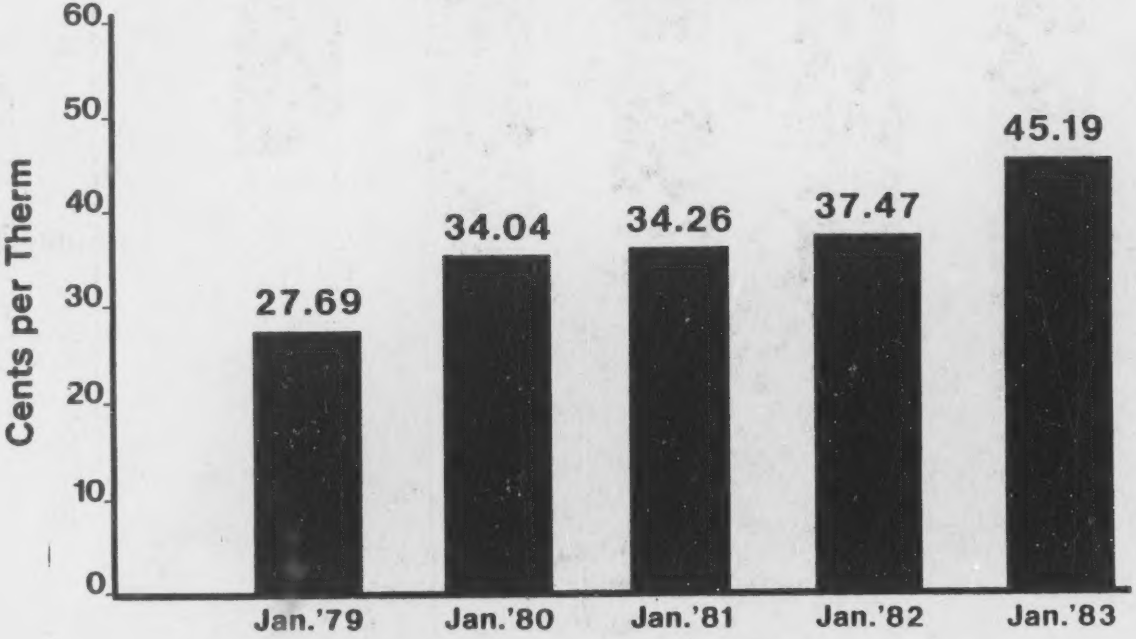
Cost Per Therm*
Residential Gas Heating Customer
(300 Therms per month)



*Includes State Revenue Taxes, but does not include any municipal public utility taxes.

Northern Illinois Gas

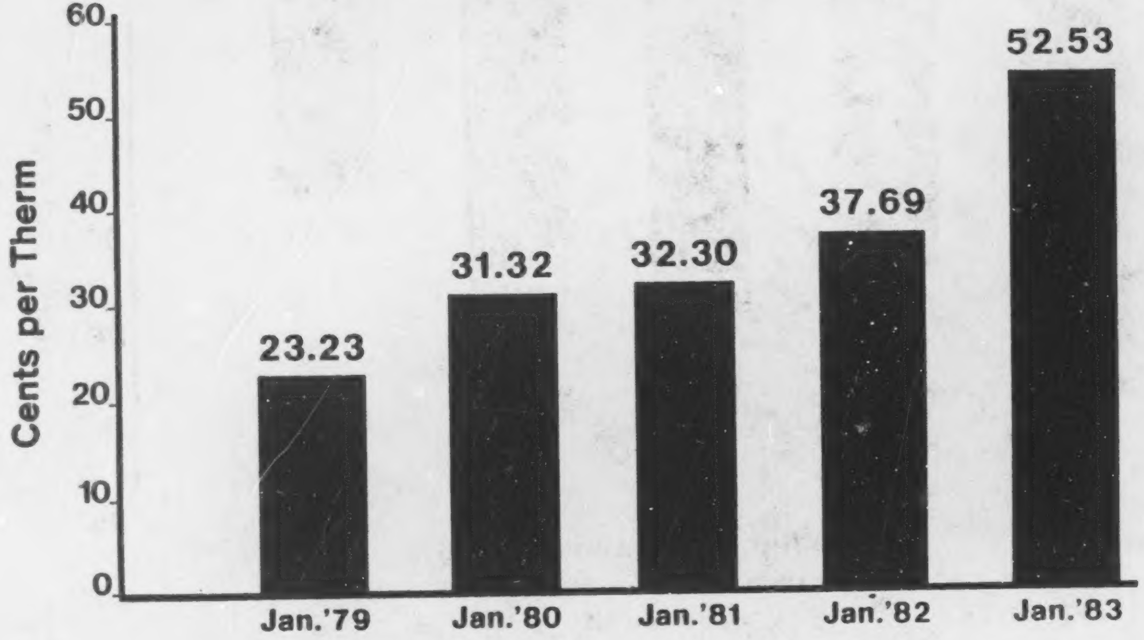
Cost Per Therm*
Residential Gas Heating Customer
(300 Therms per month)



*Includes State Revenue Taxes, but does not include any municipal public utility taxes.

Illinois Power

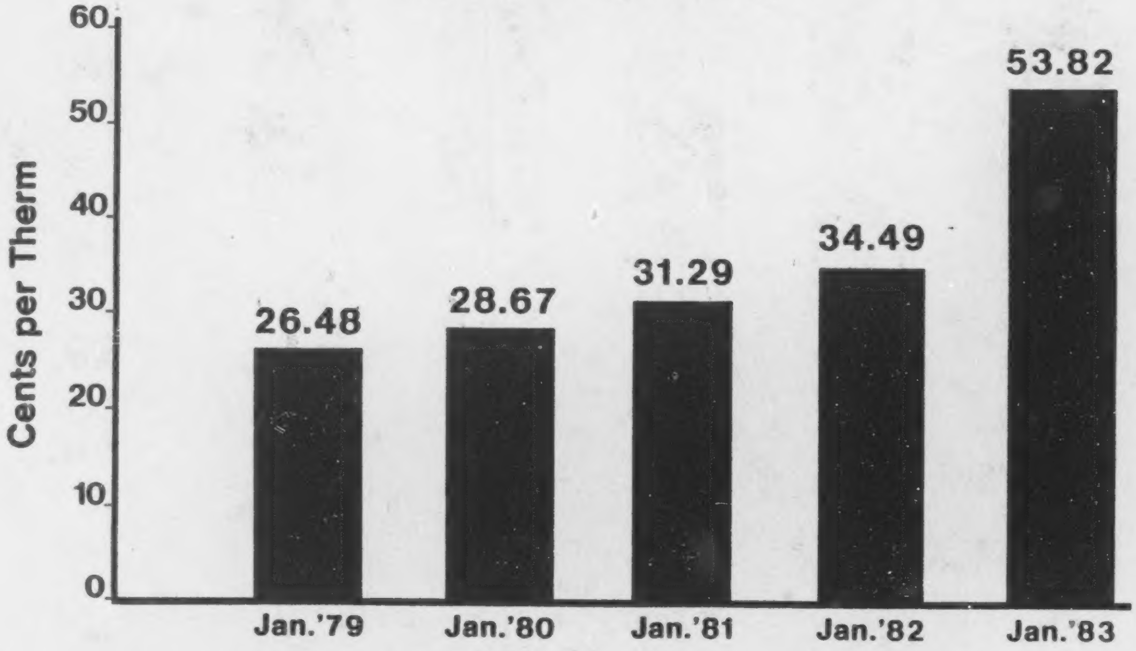
Cost Per Therm*
Residential Gas Heating Customer
(300 Therms per month)



*Includes State Revenue Taxes, but does not include any municipal public utility taxes.

Central Illinois Light

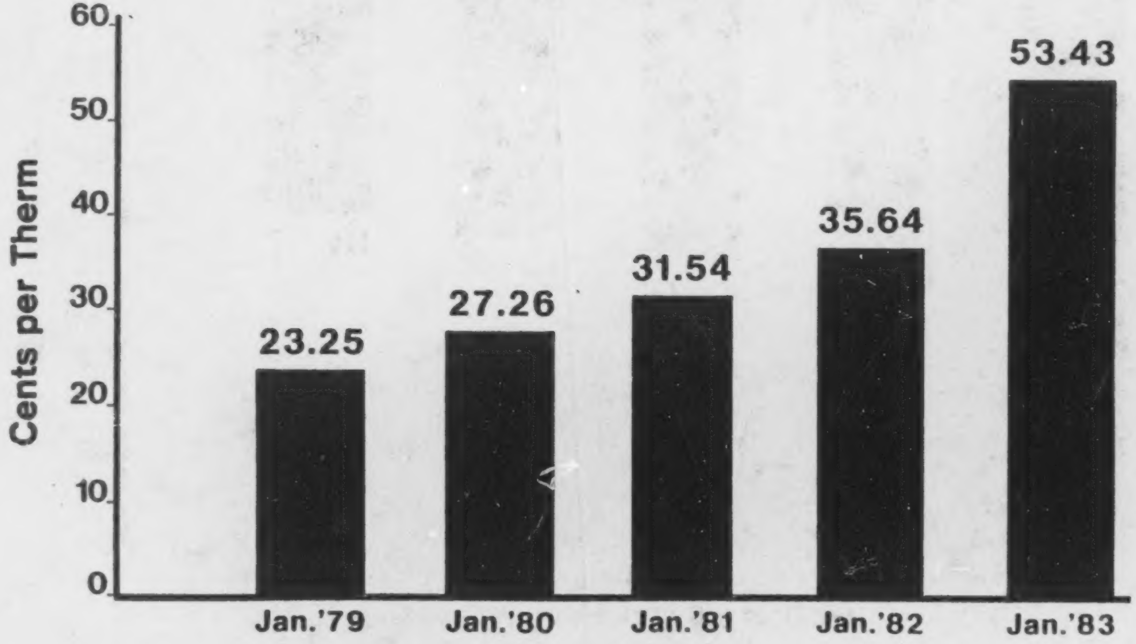
Cost Per Therm*
Residential Gas Heating Customer
(300 Therms per month)



*Includes State Revenue Taxes, but does not include any municipal public utility taxes.

Central Illinois Public Service

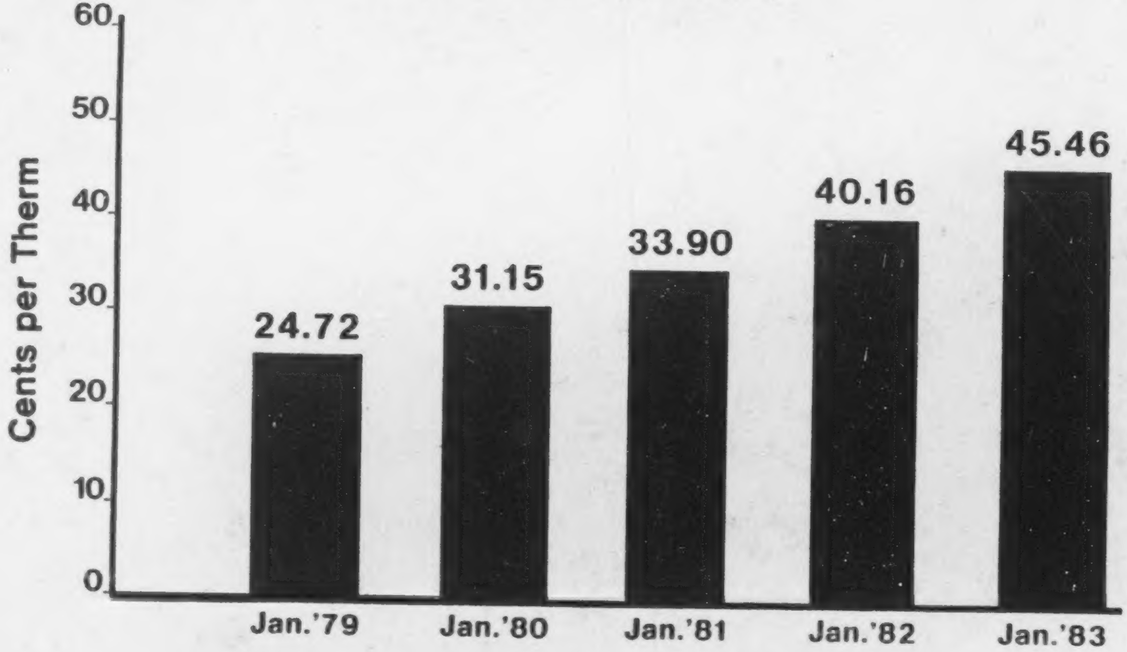
Cost Per Therm*
Residential Gas Heating Customer
(300 Therms per month)



*Includes State Revenue Taxes, but does not include any municipal public utility taxes.

Iowa Illinois Gas & Electric

Cost Per Therm'
Residential Gas Heating Customer
(300 Therms per month)



'Includes State Revenue Taxes, but does not include any municipal public utility taxes.

THE CONSUMER ACCESS PLAN: NATURAL GAS PIPELINE COMMON CARRIAGE

ILLINOIS COMMERCE COMMISSION

Printed by authority of the State of Illinois
1,000 copies — March, 1983 — No. 130

THE CONSUMER ACCESS PLAN
NATURAL GAS PIPELINE COMMON CARRIAGE

An Overview of the Natural Gas Situation

The natural gas industry is in total disarray. Throughout the country and the State, consumers are paying record high prices for natural gas–prices which are completely out of line with the economic reality of current gas supplies. Vast supplies of inexpensive gas are available from producers who cannot find pipelines to purchase their gas, while consumers anxious to benefit from less expensive gas availability cannot get their pipelines to provide it to them.[1] As a consequence of distorted pricing and adverse incentives, our domestic gas surplus has grown by 250% between 1980 and 1982.[2] Lopsided but well-intentioned Federal regulations have sent producers out to explore, develop, and produce high cost gas supplies while pipelines cut back on purchases of low cost gas to fulfill contract obligations on expensive gas. The current situation is chaotic, costly and intolerable.

Illinois has been particularly afflicted by these developments. Since the passage of the Natural Gas Policy Act (NGPA) in 1978, many Illinois residents have seen their natural gas bills increase needlessly by as much as 290%.[3] Table 1 illustrates the substantial disparities in prices charged by pipelines serving Illinois, and the severe impact of recent price increases on consumers in the central and southern portions of Illinois. The greatest price increases are found on the Trunkline and Panhandle Eastern pipeline system where the average cost of gas to distributors has risen more than 50% and 100% respectively since 1982. Two communities only 5 miles apart may see gas bills which differ by as much as 46%, for gas supplies which are chemically identical but simply had different geographical or regulatory origins.

Table 1. RATES OF PIPELINES SERVING THE STATE OF ILLINOIS Effective March 1, 1983 ($/MMBTU)

Michigan-Wisconsin	$4.38
Midwestern Gas Transmission	3.87
Natural Gas Pipeline Company of America	3.49
Northern Natural Gas	4.09
Panhandle Eastern	4.91
Texas Eastern Transmission	3.28
Texas Gas Transmission	3.81
Trunkline Gas	4.74

Source: Testimony of Donald C. Samberg, FERC Docket No. R82-105-000, Exhibit __ (DCS-16), February 16, 1983. The above rates assume 100 percent load factor.

All of the pipelines serving Illinois have attempted to build large reserves of gas to support expected annual sales far greater than current sales. This "excess deliverability" for Natural Gas Pipeline of America is so great that the pipeline has moved to dump the excess in the Texas and Louisiana intrastate markets. In 1982 Natural Gas Pipeline chose to take delivery of less $.70/Mcf gas than it had contracted to take in that year. Under the terms of its contract, however, it was obligated to pay $50 million to producers as though it had actually taken delivery of the gas. At the same time, Natural continued to purchase gas at an average price of $2.33/Mcf for sale in Illinois. Trunkline expects to pay $600 million in 1983 for domestic gas that it must buy but cannot sell, while at the same time acquiring 165 billion cubic feet of Algerian gas that is two and one-half times more expensive than readily available domestic gas!

Historically, natural gas has enjoyed a price advantage over alternative fuels such as boiler grade fuel oil. In 1983, this advantage will be reversed in some parts of Illinois. Plainly, the current attractiveness of alternative fuels is an artificial result of crippling price distortions. The net effect, however, is that industrial customers able to switch from natural gas to alternative fuels are doing so at an alarming rate. As these customers leave the natural gas transmission and distribution system, the remaining customers (mostly residential and commercial) who cannot switch are forced to bear a greater share of the system's fixed costs.

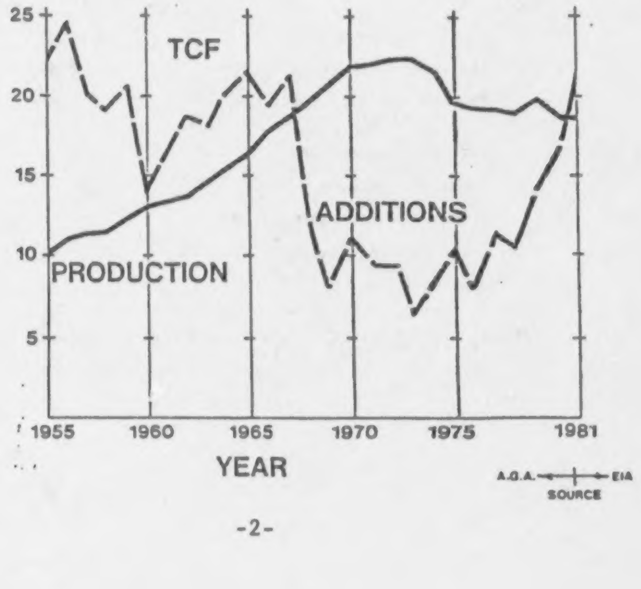
A Primer on How We Got into this Predicament

The road to the current gas calamity was paved with good intentions. The Natural Gas Act of 1938 brought interstate pipelines under Federal regulation and required that pipelines demonstrate massive, long-term reserves as a condition for certification. The 1954 Phillips decision by the U.S. Supreme Court required the Federal Power Commission (FPC) to set wellhead prices on all natural gas sold in interstate commerce so as to capture for consumers the benefits of the low-cost gas supplies then available.

Largely as a consequence of FPC failure to increase wellhead prices to reflect the increasing costs of exploration and production of new gas supplies, new gas discoveries fell and producers gradually dedicated little new gas to the interstate markets. (See Figure 1) By the early 1960's,

FIGURE 1.

NATURAL GAS PRODUCTION VS. ADDITIONS, LOWER 48



problems began to emerge when interstate pipelines experienced increasing difficulty in obtaining new gas supplies. By the mid-seventies, severe curtailments of gas supplied to existing customers were common and in many parts of the country new gas customers were not permitted on the system. Because new domestic gas supplies were not forthcoming, pipelines turned to "supplemental" gas sources such as Algerian gas, which is liquified and shipped by tanker to the United States, deliquified, and then introduced into the interstate system. There was widespread skepticism among pipelines that wellhead prices would ever be decontrolled by Congress, and further there was disbelief that higher wellhead prices would actually bring forth greater supplies of domestic gas. In an unusually painful display of vindictiveness, history quickly proved both of these views to be plainly wrong.

In 1978, after considerable debate, compromise, and general misgiving, Congress laid the groundwork for the eventual deregulation of wellhead prices. The Natural Gas Policy Act (NGPA) established an elaborate array of 26 categories of natural gas. Based on such factors as the depth of the well, the proximity of the well to other gas producing fields, and the date that gas began to flow, the NGPA set ceiling or "incentive" prices which were intended to induce greater production. It also provided for a gradual increase in these wellhead prices so that by 1985, at least new gas prices would achieve parity with oil prices. Despite its shortcomings, the NGPA did encourage exploration and production to such a degree that our current domestic surplus is an embarrassment.

Many pipelines, still concerned with curtailments, sought to secure whatever new gas supplies were available, regardless of cost. To the extent that its old gas prices were unaffected by the NGPA, a pipeline could purchase new gas at $7/Mcf, average that price in with old gas at $.50/Mcf, and sell to distribution companies at an average or "rolled-in" price of $2.50/Mcf. The availability of old gas has been referred to as a "gas cushion" for this reason. Understandably, the pent up demand for new gas supplies after the NGPA created a seller's market. Producers were able to negotiate favorable long-term contracts for their new gas, with high "minimum take" provisions. Under these clauses, a pipeline is obligated to pay for a certain quantity of gas each year, regardless of whether the pipeline actually needs or takes that quantity of gas in a particular year. Pipelines serving Illinois currently pay almost $700 million per year in the form of "prepayments" for gas they cannot market. These charges are passed on to Illinois gas customers by the Federal Energy Regulatory Commission (FERC, the successor organization to the FPC).

Overall, the NGPA has caused large increases in new gas reserves, extremely high prices for deep gas, and a greater willingness on the part of producers to sell gas from their reserves at an increased annual volume. Concurrently, the curtailment problem led to reckless gas purchase decisions by pipelines who overestimated the marketability of more expensive gas made available by the NGPA. Transmission costs also rose sharply in recent years as a result of higher interest rates and expanded pipeline investment in storage facilities and main line extensions.

The response of consumers to higher gas prices in the post-NGPA period (1978-1983) was to cut back on consumption.[4] Some of this response was in the form of conservation, some was due to the recent recession, and some was the result of fuel switching as oil prices began to fall. As gas sales declined, pipelines were forced to cut back on their gas purchases from producers. Incredibly, the first gas to be cut back in many cases was inexpensive gas. Older contracts for inexpensive gas were generally written with lower "minimum take" requirements than was common in contracts for new, expensive gas. Thus, by cutting its purchases of new gas, a pipeline could suffer a penalty. Since the new high cost gas contract had been approved by the Federal Energy Regulatory Commission and was in compliance with NGPA ceiling prices, these pipeline responses are presumed to be lawful. It is the official position of the FERC that its responsibility with respect to pipeline gas purchases is largely limited by law to ensuring that the gas prices comply with the NGPA. Under the current regulatory framework, consumers are obligated to purchase expensive gas while pipelines decrease their "takes" of less costly gas.

The outlook for consumers under existing pipeline regulation is bleak. Although gas prices paid by consumers are already far greater than economic reality permits, in late 1982 the pipeline industry commenced a massive LNG importation program and increased purchases of expensive Canadian gas through the Northern Border system. These projects involved substantial capital costs and provide for gas prices well above the average price of gas available domestically. Under the pretext of protecting consumers, the current Federal policy is to put a cap on prices that can be paid to domestic producers while giving routine approval to expensive projects to import gas at prices between two and three times the average domestic price cap! Consumers plainly do not need to be protected from $3/Mcf domestic gas prices if it means they are forced to purchase $7/Mcf LNG and $5/Mcf Canadian gas as an alternative.

Even though pipelines have generally not purchased any new gas supplies during the past six months, consumer prices for gas are expected to continue to rise. Further losses of load will continue as consumers respond to higher prices by conserving and fuel switching. Prices will then rise further as fixed costs are spread among fewer customers and as pipelines back out even greater quantities of low cost gas. The insanity of gas market disorders must not be permitted to continue or to ever occur again.

Who is at Fault?

In order to focus on the root of our current problems it is necessary to describe the primary functions of a gas pipeline system and its regulatory environment. It should be evident that a gas pipeline today is not simply a benign and disinterested transporter of gas from producing fields to distribution companies. Whereas oil pipelines, railroads, and other common carriers have no financial interest in the commodities they transport, natural gas pipelines contract directly with producers to purchase almost all of the gas they carry. Moreover, many pipelines are vertically integrated and own gas producing wells and other facilities either directly or through affiliates.

When a pipeline purchases gas from producers, it is often the only buyer a producer faces. Because pipeline extensions to new fields are relatively costly, there are rarely more than a few pipelines able to bid for a producer's supplies. This situation gives pipelines considerable market power in their negotiations with producers. The producer is further constrained by NGPA ceiling prices which establish the maximum that he is able to charge for his gas. Recently, producers have sought to extract contract concessions from pipelines, such as high minimum take provisions, because of NGPA price controls. Although all interstate producer/ pipeline contracts are routinely filed with the FERC, regulatory oversight is largely limited to ensuring that NGPA ceilings are not exceeded. The question of whether a pipeline could have paid a lower price, negotiated more favorable minimum take terms, or purchased a less expensive NGPA category of gas from a different producer is never raised in FERC's review of pipeline contracts.

Further distorting the pipeline's incentive to negotiate gas contract terms favorable to consumers is the ability to impose minimum take and sole supplier clauses on the pipeline's customers, i.e., the distribution companies. In this way, the pipeline is able to transfer both the cost and the risk of its producer contracts directly to consumers. This risk transfer is legitimized by routine FERC approval of pipeline tariffs at the distribution company end of the pipeline system.

An additional problem has resulted from the availability of cushions of inexpensive gas. Pipelines have tended to base their gas purchase decisions on the average rather than the incremental cost of gas. If a pipeline has a "cushion" of inexpensive gas, it will be more willing to pay a higher price for new gas than it would pay without the cushion. Indeed, pipelines have bought and continue to buy gas which is so expensive that it cannot be sold at the price the pipeline pays! Only by averaging that price with less expensive gas prices can the pipeline market such gas. The effect of this has been to send signals to producers that there is a market (at least with the pipelines) for expensive gas. Producers have responded with increased exploration and drilling activities for expensive gas, a wasteful and inefficient use of resources.

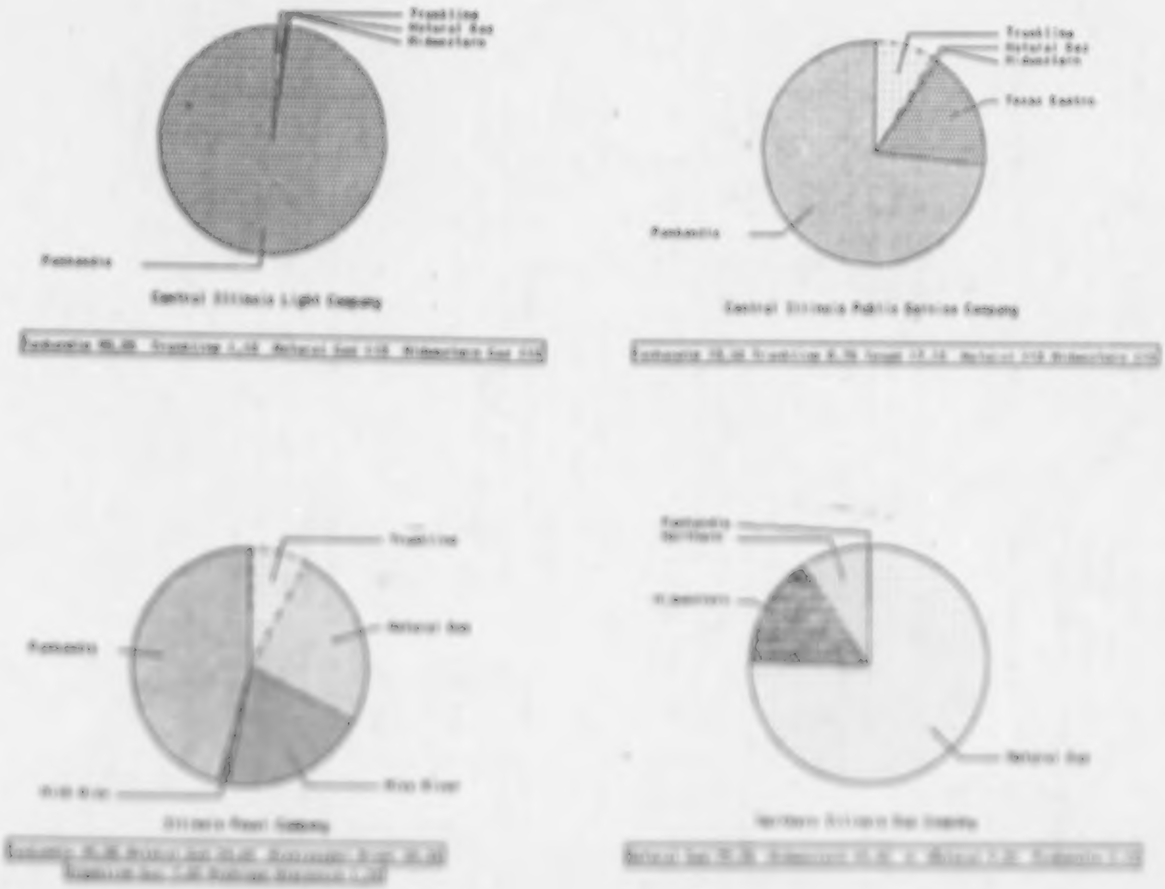
Although the basic transportation function pipelines perform is relatively uncomplicated, there are numerous deficiencies in the rate designs pipelines use to recover the fixed costs associated with that function.

At the distribution end of the system, pipelines once again enjoy a considerable degree of market power.[5] Although in urban areas there are on average 3.6 pipelines serving each distribution company, the number is much closer to 1 for smaller communities. Figure 2 shows the percentage of gas supplied by various pipelines for several of the major gas distributors in Illinois. Central Illinois Light Company, for example is largely captive to Panhandle Eastern for its gas supply. Unfortunately, even when a distributor is served by multiple pipelines most of the normal opportunities for competitive bargaining are not available. In many cases, pipeline tariffs contain "sole provider" and "minimum bill" clauses which are used by the pipeline to discourage a distributor from shopping for lower priced gas. Under these FERC approved clauses, the pipeline is able to charge higher rates if a distributor elects to purchase some of its gas elsewhere. As a consequence, any attempt by a distributor to interconnect with a new pipeline with less expensive supplies could lead to higher overall gas costs.

To the extent that distributors are captive customers of the pipeline(s) serving them, they are left with little recourse but to pay the FERC-approved tariffs. State regulatory commissions lack jurisdiction over interstate pipelines and are largely powerless to provide appropriate incentives to pipelines to secure least cost mixes of gas and to offer non-discriminatory tariffs. Pipelines have no obligation to carry any gas other than the gas they themselves own for their customers. Distributors are unable to contract for gas supplies directly with producers and utilize the pipeline only as a transporter of gas. Producers also have no rights to require the pipeline to transport gas for them directly to ultimate customers.

As a public utility, a natural gas pipeline has an obligation to serve distribution companies, and that obligation is presumed to require that the pipeline purchase gas for resale to its customers. When a pipeline's purchased gas costs increase, the pipeline files a notification with FERC requesting permission to immediately pass the higher costs on to customers. Traditionally, FERC allows these higher rates to go into effect subject to refund while the filing is reviewed. As mentioned earlier, however, FERC reviews only whether the higher price paid by the pipeline is consistent with the NGPA. FERC does not currently recognize a statutory responsibility to review the prudency of the pipeline's decision to purchase a particular quantity of expensive gas. This version of regulatory "open house" is especially troublesome when the higher costs are associated with wells and facilities owned directly by the pipeline. Incentives for pipelines were further distorted by a 1982 U.S. Appellate Court decision which held that a pipeline could pay to its own producing affiliate an amount no greater than the highest amount it paid to non-affiliated producers of similar gas. This incredible decision plainly encourages pipelines to find a supply of very expensive gas which can be used as a basis for increasing the price it pays to its own producing affiliate. All such costs are passed on to distributors who lack access to the vast supplies of less expensive gas producers currently want to sell.

FIGURE 2.



Central Illinois Light Company

Central Illinois Public Service Company

Illinois Power Company

Northern Illinois Gas Company

The Consumer Access Plan

The current surplus of domestic gas supplies is persuasive evidence that incentive pricing under the NGPA was effective. However, because of excessive rigidity and a general lack of competitive pressures, natural gas prices under the NGPA have risen far more on average than was necessary. Consumers could have enjoyed the same abundance of new gas supplies at much lower prices under a more competitive industry structure.

The Reagan Administration (S. 615 and H.R. 1760) has proposed to amend the NGA and NGPA to provide greater flexibility in natural gas markets and to introduce a greater degree of competition in the industry. The Administration's proposal provides for consumer protection through greater consumer access to low cost gas supplies, but requires that consumers appeal to FERC for special permission to make direct gas purchases, thus failing to correct non-competitive pipeline practices. Plainly, this approach is not sufficient to ensure a competitive and responsive natural gas industry. The Illinois Commerce Commission believes that sufficient competition to ensure lower prices for all consumers can be achieved only through a far stronger consumer access provision which thoroughly restructures natural gas pipeline regulation.

The major provisions of the Consumer Access Plan are summarized below.

- Immediately change natural gas interstate pipeline status to common carriage;
- Declare null and void all existing pipeline-distributor contracts and "sole supplier"/minimum bill" clauses.
- Eliminate pipeline obligations to purchase gas for distributors;
- Authorize FERC to establish new common carrier obligations and transportation/storage tariffs for pipelines;
- Direct the U.S. Department of Justice to report to Congress on the adequacy of competition under existing pipeline vertical integration;
- Declare all new gas and gas not under contract as "free access gas" which may be purchased by distributors and transported under tariff by pipelines;
- Require that by 1/1/1985, for any gas contracts not renegotiated, either party may exercise "market out" rights and dissolve contract obligations;
- Authorize FERC to require pipeline interconnections and system extensions upon a demonstration of public convenience and necessity.

As common carriers, pipelines will file tariffs with FERC which cover reasonable transportation and/or storage charges only. Any customer, such as a local distribution company, could contract directly with producers or indirectly through brokers for his gas requirements. The distributor would pay the pipeline for actual transportation costs incurred at the tariffed rate, and would neither expect nor receive any further regulated services from the pipeline.

This change in pipeline regulatory status will immediately introduce competitive forces into that sector of the industry which has traditionally been least competitive. There is no justification for continuing to endow natural gas pipelines with enormous degrees of market power and statutory insulation from market pressures.

Responsibility for gas purchase decisions must be placed closer to ultimate consumers with oversight by state public utility commissions who will be more responsive to state and local concerns. Producers will support this change in pipeline status as eagerly as consumers because it will expand their markets for gas sales.

The Consumer Access Plan provides for the renegotiation of pipeline-producer contracts on a phased-in basis which parallels the Administration's proposal. Many existing contracts now held by pipelines are already unenforceable because pipelines will be unable to market the quantities of gas to which they are committed at current prices. Remaining contracts should be renegotiated by 1/1/85 so that pipelines do not institutionalize further these harmful price distortions.

Whereas the Administration proposes to introduce regulatory obstacles between consumers and gas supplies (i.e., petition FERC for special permission), the Consumer Access Plan declares all pipeline-distributor contracts null and void and immediately provides for direct consumer access to producers. This is the only mechanism which will ensure that consumers receive immediate and overdue benefits from the surplus availability of low cost gas.

The Illinois Commerce Commission is concerned that the vertical integration of natural gas pipelines may provide pipelines with anti-competitive incentives and opportunities. To ensure that the natural gas industry will be fully competitive under the Consumer Access Plan, Congress must direct the U.S. Department of Justice to examine natural gas pipeline vertical integration and report on corrective actions necessary to prevent cross-subsidization of competitive operations through regulated common carrier tariffs.

Common carriage is a well-understood and useful regulatory framework which is now serving the public well, particularly in the case of oil pipelines. The solution proposed here is not a unique one. It is the current regulatory license now afforded to gas pipelines which is inappropriate and without precedent in this country's regulatory history. The Illinois Commerce Commission cannot support a national policy premised on the view that interstate pipelines will make better gas purchase decisions than natural gas customers themselves.

Summary of Consumer Access Plan Benefits

The Illinois Commerce Commission estimates that conversion of natural gas pipelines to common carriage will yield national benefits to consumers on the order of $5 to $10 billion per year. These benefits are referenced to the alternative of continuing with current pipeline regulation under the NGPA.

In comparison with proposals which would reimpose low wellhead ceiling prices while retaining current pipeline regulation, common carriage will yield benefits of $12 billion by 1990.

Although consumers in central and southern Illinois will realize the most substantial decreases in natural gas bills, real price decreases are also projected for customers in northern Illinois as well. Overall, the Consumer Access Plan will

- Guarantee immediate customer access to less expensive gas;

- Ensure customer access to other pipelines;
- Force pipelines to be more responsive to market forces;
- Eliminate pipeline market power over producers and customers;
- Reduce regional disparities in gas prices by squeezing out high cost gas;
- Move gas purchase decisions from pipelines to customers (distributors and large end users); and
- Eliminate waste in the interstate pipeline system.

FOOTNOTES

1. For example, Panhandle is currently reducing its take of $.64/Mcf gas from Kansas to make room for $7.38/Mcf regasified liquified natural gas (LNG) from Algeria.

2. In Illinois, Natural Gas Pipeline Company of America, which provides roughly 70 percent of the gas consumed in the state, expects the availability of gas to exceed its requirements by more than 27 percent in 1982 and 1983.

3. Since 1982, the price of gas to customers of Central Illinois Light Company has increased more than 60 percent.

4. In Illinois, total gas sales declined by 12 percent between 1978 and 1981.

5. There are 1,443 gas distribution companies, 1,012 of which are served by only one pipeline. For the remaining distributors, the average number of pipelines is 3.6. Most urban areas are served by gas distributors who have multiple suppliers. Source: David Mead, *Concentration in the Natural Gas Pipeline Industry*, FERC/ Office of Regulatory Analysis, August 1981.

Mr. Simoneaux. I have a correction in my presentation, if it would be appropriate at this time?

The Chairman. Surely.

Mr. Simoneaux. The footnote on page 1 of the statement we submitted is the word "not." It should be "now" instead—n-o-t, it should be n-o-w.

Senator Ford. That makes a difference?

Mr. Simoneaux. It does make substantial difference. Thank you, Mr. Chairman.

The Chairman. Mr. O'Connor, we have heard some testimony concerning the impact upon Illinois consumers of gas in Canada.

What is the proportion of the natural gas market in Illinois that comes from Canada?

Mr. O'Connor. The portion of Illinois, Senator, I cannot tell you right off from the top of my head now. However, the overall financial impact on Illinois consumers of the rolling in of Canadian natural gas at its current price is essentially built in about 8 percent of fat into the bills that our people pay.

The Chairman. How would you suggest we deal with that question across our international border?

Mr. O'Connor. If indeed we had a system in this country of a national market in gas, that would result in an immediate and significant downward pressure on prices and opening up gas supplies to willing buyers. You don't even have to deal with that directly. Most of the Canadian gas is falling into the Midwest and into California. That high-priced gas would be squeezed out almost overnight and the Canadians would be down here in no time asking for a lower price.

The Chairman. I assume you mean by that abrogate take or pay contracts or other such contractual provisions?

Mr. O'Connor. Yes. Utilities would have the right to go buy their own gas and simply displace that in the pipeline for previously contracted for gas.

The Chairman. Senator Ford?

Senator Ford. Thank you, Mr. Chairman. I am going to have two or three questions and I will limit my questions to Ms. Murrell, because I think she represents a broad range of individuals who are concerned with the increasing cost of natural gas.

First, Laura, let me congratulate you and your commission for its long-held view on incremental pricing. I opposed incremental pricing at the time as the Commission did, and you agreed then that it continues to pose a problem for State regulators by taking away some of their flexibility.

What kind of problems does it give you?

Ms. Murrell. I understand from my staff that it just really is nightmarish to deal with, to have to deal with the prices published each Monday and try to implement them. We do not have that many in Kentucky, users big enough to come under it, but for those that are, it is a difficulty.

Senator Ford. Well, the administration's bill allows either party to exercise an option to market-out contracts between producers and pipelines.

What is your opinion about an extension of market-out contracts between local distribution companies and pipelines?

Ms. **Murrell**. Well, that is something like what Mr. O'Connor is talking about I believe where he is talking about letting distributors out.

My concern is that I am afraid that if we start interfering with the historical relationships in the market that those people who are not big enough or positioned where they can themselves deal with the market are going to be left with even higher cost gas.

Our bill provides for looking at these issues. My concern is that the big distribution companies or the well situated distribution companies would benefit and the smaller distribution companies would end up with even higher cost gas.

Senator **Ford**. Various distinct commissions have been active in the Federal Energy Regulatory Commission proceedings on the fraud and abuse standards.

Do you feel the Commission has been responsive to these complaints?

Ms. **Murrell**. Well, I guess we will have to wait and see how they rule on the Columbia Gas decision. They haven't been to date.

We like the ALJ's, we like the administrative law judge's decision in that case, and we are waiting with bated breath, with everyone I think.

Senator **Ford**. Do you believe they do have the administrative authority to include a prudent standard for gas purchasing practices and that they should exercise that discretion by including in that what constitutes abuse?

Ms. **Murrell**. Yes. I have studied their opinion in which they found that they did not and was greatly disappointed by it. At this point I don't know whether we could expect them to back up and change or whether it is going to require legislation, but I believe that they did when I read the briefs on those issues.

Senator **Ford**. In the past few days if you have been here we have all heard a lot from Senators about the kind of mail and kind of complaints they are getting from the public about natural gas pricing increases.

The regulatory commissioners are the ones that really are on the firing line. What are you hearing?

Ms. **Murrell**. A lot, and just a complete inability to understand what is happening, and that is why I am here. You know, I told them I can't do anything. Only Congress can, so here I can asking for your help.

Senator **Ford**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much. Senator Hecht?

Senator **Hecht**. Mr. O'Connor, I was just reviewing your proposal. You address the problem immediately in your opening statement but you do not say whether you are in favor of the President's proposal or not.

Mr. **O'Connor**. Senator, the President's proposal without taking a serious step for bringing buyers and sellers together, without the intermediation of monopolistic pipelines, will, I am sad to say, not accomplish very much at all, and if I could just take a moment to comment on one critical point here that my colleague from Kentucky raised about the position of smaller utilities and their capacity to purchase, if you were to make pipelines common carrier this afternoon, by Monday morning the sellers of gas would be knocking on the door of those utilities trying to unload that gas.

It is not a problem that you have got to have smart purchasers out there. The sellers will be smart. They are going to drop those prices and they are going to go down. It is like any other place in this economy where you have got an oversupply. You can have the dumbest buyers in the world and they are going to benefit.

Senator HECHT. While this might be a good idea in the abstract, are you sure that sufficient pipeline capacity exists to give every potential buyer equal access to the pipeline?

Mr. O'CONNOR. We have looked at that question and feel confident really on two points—first, that if you look at the current system there is more than enough capacity in the existing system to carry all the gas that is being purchased. With the kind of swapping arrangements that would exist in a free market system you would really not have any problem at all. Frankly, any problems that you did have in that kind of a system would be genuinely trivial compared to the dislocations that we are forcing on ourselves by the existing system.

Senator HECHT. Well, in your judgment, is the President's proposal a step forward or backward?

Mr. O'CONNOR. It takes some important steps forward, but unless you really deal seriously with every aspect, it is another program where we go down the road paved with good intentions. You can't do some of these things halfway. Otherwise we just perpetuate these Rube Goldberg contraptions that are going to put us all back here in a year or two with exactly the same problem.

I would like to be able to come out wholeheartedly and support it, but the problem is on such issues as the role of pipelines and so forth, if you don't deal with that forcefully, then a lot of the other well-intentioned points just miss the boat.

Senator HECHT. Thank you very much; no further questions.

The CHAIRMAN. Thank you, Senator. Senator Metzenbaum.

Senator METZENBAUM. I want to be clear as to where each of you is on the issue.

Mr. O'Connor, do I understand that if you had to, you are opposed to the President's bill?

Mr. O'CONNOR. I am in all frankness quite ambivalent about it. I see some good aspects to it, but unless it really deals with, something with the role of the pipelines, Senator, we are going to be very disappointed in the proposal as it becomes law.

Senator METZENBAUM. If you had to vote on it as we have to vote, yes or no, would you vote yes or no?

Mr. O'CONNOR. You won't let me vote "maybe"?

Senator METZENBAUM. That's right.

Mr. O'CONNOR. I feel that I would probably vote no and feel very badly about it. It needs some work.

Senator METZENBAUM. Mr. Coleman?

Mr. COLEMAN. We feel that the bill takes some important, if imperfect, steps forward in the contract part of the legislation.

However, it is stated in my testimony we feel also that the deregulation of all old gas in particular would be very harmful to our economy, and place an unfair burden on consumers and some of them I think vote. At this point I vote no.

Senator METZENBAUM. Mr. Simoneaux?

Mr. SIMONEAUX. I would vote yes on the basis that it is a step forward toward what Mr. O'Connor is describing.

Incidentally, the bill does have provision where the FERC could authorize, have some sort of authority with respect to the contract area, status of pipeline. It goes somewhat along the lines Mr. O'Connor is describing, not as far apparently as he would like the bill to go. It does cover that to some degree, and frankly, I would have to say on balance it is a good provision and what Mr. O'Connor says has been considered in the bill may not be as complete as he would like it.

Senator METZENBAUM. Mr. Lederer?

Mr. LEDERER. I think as we say in the statement that the concept of deregulation of price at the wellhead which seems to be the central feature of the President's bill is not by itself a solution, and therefore cannot be supported by itself.

The problem of pipelines, the problem of State regulators having no ability to really get efficiency at the consumption level reflected in the supply picture and the automatic passthroughs are all things that are just not really seriously addressed in the President's bill.

Senator METZENBAUM. How would you vote?

Mr. LEDERER. No.

Senator METZENBAUM. Ms. Murrell?

Ms. MURRELL. As I said earlier, the position of the NARUC taken in its 1981 convention was against accelerated decontrol, and I think it is clear from the discussions we have had this past week that the consensus on that has not changed.

As chairman of the Kentucky Public Service Commission, I would have to vote no as well.

Senator METZENBAUM. If the issue were simple, for or against a simple decontrol bill at this point, how would you vote?

Ms. MURRELL. No.

Senator METZENBAUM. Mr. Lederer?

Mr. LEDERER. No.

Senator METZENBAUM. Mr. Simoneaux?

Mr. SIMONEAUX. If it is a simple decontrol bill, immediate decontrol? I think that would be totally impractical. I would have to say no on that.

Senator METZENBAUM. Mr. Coleman?

Mr. COLEMAN. The same.

Senator METZENBAUM. Mr. O'Connor?

Mr. O'CONNOR. No.

Senator METZENBAUM. Mr. Simoneaux, you said in your testimony—thank you in answering my question yes or no. You stated in your testimony that by removing wellhead price controls on January 1, 1986, while retaining consumer protections, it will permit the market to move toward decontrol in an orderly fashion.

Would you be good enough to explain to me how as of January 1, 1986, there would be any consumer protections, and second, how would the market be able at that point to move through, move toward decontrol in an orderly fashion because as of that date you would have total decontrol?

Mr. **Simoneaux**. I believe the phrase—I think, Senator, your point is well taken. The phrase I think is misplaced. The consumer protection, of course, would occur in the interim from the same statute but from the standpoint of what we think is ultimately a fair treatment of all consumers nationwide, a decontrolled market would be in favor of the consumers.

The current NGPA and any attempt to predict the natural gas market on an artificial basis is going to hurt consumers in some part of the country and aid others, and that is where we think decontrol treats all consumers fairly, so the statement is yes, we think it is a benefit for consumers on that basis.

Senator **Metzenbaum**. You are saying that when you have decontrol you will have more natural gas. Therefore, the consumers will be protected by the free market. Is that the thrust of your remarks?

Mr. **Simoneaux**. Not entirely; that is part of it. Of course, as we have more gas, then the price would drop normally.

Senator **Metzenbaum**. Let me ask you a question. We have too much gas now. As a matter of fact, immediately after passing the Natural Gas Policy Act, a great architect of that program, James Schlesinger, said suddenly we have a boom, a glut of natural gas, and it is just temporary. Well, obviously he was wrong. But he was wrong in supporting the Natural Gas Policy Act and drafting it in the first instance.

Where we have had a glut of natural gas, prices have continued to rise. Some would argue that it is because of the Natural Gas Policy Act. There is nothing in the Natural Gas Policy Act that requires prices to go up. All it provides is a maximum. It doesn't provide that the free market can't work to keep prices down.

Now why are you saying to me that when you have a forecast after decontrol that you are going to be bringing prices down there when they are not coming down now, and they could?

Mr. **Simoneaux**. The fallacy in the NGPA basically with respect to your question is this as we see it—it does not maintain increasing prices, but it gives powerful incentives to have the very herky-jerky approach to the market.

For example, in Louisiana we have section 107 gas that one time was selling for $10 per Mcf. The only reason it went way, way above the market value of gas under anyone's estimate, and we think that was wrong, incidentally, that was not an appropriate thing to happen in the market. We didn't support that. The only reason that happened is the incentives that you have—the low price, deep cushion pipelines who were able to then bid way above market value of gas because they had something way below market value, and of course, that is where the pipelines generally speaking got themselves in trouble, trying to anticipate what would happen in a disordered market under the NGPA.

We don't support prices of gas that are above a market value of gas, but to reach that those that are above it have to come down. Those that are below have to come up, and then you will have some average price that your constituents will be paying roughly the same, and our people in Louisiana will be paying roughly the same. Otherwise it is just a matter of happenstance whether one State has a particular price as opposed to another under different conditions. It is totally happenstance in NGPA, and that is why we think it is simply unworkable.

Senator METZENBAUM. Mr. Simoneaux, there is no evidence in the gas market that normal economic laws apply, that the law of supply and demand works, because as Mr. Coleman has pointed out and, as we all know, you can't go to an alternative gas supplier if you are a homeowner and very seldom even if you are a business person. We have had now what, 5, 6 years under the Natural Gas Policy Act. Prices have continued to escalate, and although you talk about this question of the mix and you talk about the take or pay contracts, at least that implicit in what you are saying is the fact that normal economic operations are not occurring in the gas market. They can't occur as long as you have some people who control the pipeline and some people who control the supply as well as the distribution.

Mr. SIMONEAUX. Senator, we have never tried in the free market, and I will agree with you in terms of the origin of the pipeline industry 30, 40, 50 years ago when it started, you did not have a mature pipeline industry. Today I think you have a mature pipeline industry or one just about mature, and of course, with Mr. O'Connor's comments, I think you do have a very realistic chance for a competitive market that you would not have had 30 years ago, 40 years ago when NGPA came into effect, was required, because you did not have a mature pipeline industry.

I think today you do and I think that what we end up trying under the current circumstances—I want to emphasize what Mr. O'Connor says, has a lot of greed to it, and this bill begins to address it. It doesn't go all the way, but I am not an expert all together on pipelines, and I would draw here on my knowledge and final conclusion, but I think we are going in the right direction, Senator.

Senator METZENBAUM. Mr. Simoneaux, the only ones who take the position that you do, interestingly, happen to be geographically located in the producing States of Texas and Louisiana.

Mr. SIMONEAUX. Senator, I would like to say also that our State consumes more gas than any other State in the country, and we pay higher prices, for example, than my neighboring colleague in New Jersey, as a rule for gas. It is an anomaly. We are here as a consumer just as much as we are a producer.

Senator METZENBAUM. I almost have to say that it almost serves you right because you haven't helped us to try to keep down gas from the standpoint of Louisiana. It is almost poetic justice that your people pay more.

The CHAIRMAN. Senator Melcher?

Senator METZENBAUM. I only say that in the absence of Senators Long and Johnston!

Senator MELCHER. Ms. Murrell, is it a view of the National Association of Regulatory Utility Commissioners that the State regulatory commissioners have jurisdiction over gas produced on Indian reservations?

Mr. MURRELL. I don't know the position on that issue, and I wasn't familiar with the issue. Would you like for us to answer for the record?

Senator **Melcher**. Yes. Perhaps you do that. I am just laying the groundwork for my next question which I would like you to provide me in particular your view for your association.

Under the bill adopted in the last Congress, Indian tribes may enter into joint ventures with energy companies, and I would like to know your view, in the view of the association, of whether in light of that provision of law, new provision in law, whether or not the position of the association is that they indeed do have authority to have jurisdiction over natural gas that would be produced under that new provision of law?

Ms. **Murrell**. We will endeavor to answer that for you.

Senator **Melcher**. I thank you. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator. Senator Warner?

Senator **Warner**. Thank you, Mr. Chairman. Throughout this hearing several of us have raised the question of fuel assistance programs and the possible addition of a title here.

Briefly, if each of you could answer how effective those programs have been in your judgment, whether or not the structure of the program as a part of this proposed legislation is predicated on gas prices rising above shall we say the price as set in here this morning?

Ms. **Murrell**. Well, in Kentucky this year under the LIESP program which was the acronym for the low income energy assistance program in Kentucky, the average payment was between $150 and $250.

Given the present cost of gas or electricity for heat, that didn't go a long way, and I guess we would have to say we need more payments.

Senator **Warner**. Is it an effective means to help these low-income people?

Ms. **Murrell**. Yes. I think it is helping the consumers and to the extent that it is also getting some of the bills paid it is helping the other consumers who are paying the uncollectibles now.

Senator **Warner**. Do you think we should examine the possibility of putting in a title in this legislation that applies for assistance in gas prices?

Ms. **Murrell**. Yes; I certainly would.

Senator **Warner**. Mr. Lederer?

Mr. **Lederer**. I might say that just in the last year alone in the Washington, D.C. area, that because of the automatic passthroughs, the price of our gas bill went up 15 percent, and the passthroughs themselves increased 132 percent. That provides a context for evaluating the effectiveness of these programs.

I really don't think there is ever going to be enough money to provide proper compensation to pay these bills without finding a solution to the overall structure of the market and getting some competitiveness in the marketplace.

It is one of the big problems, Senator, that there is a lot more than poor people that are being hurt. Middle-class people, businesses are being hurt, and obviously you can't end up putting the whole U.S. Treasury behind the payment of the utility bills for the whole sector of the consuming public, so yes, a program in a short-run meeting rates, but there is no answer in the long run if we don't solve the problem of just bizarre marketplace.

Senator WARNER. That I understand.

Mr. SIMONEAUX. Senator Warner, I don't know of course your procedures here to amendments, what it would mean overall to the bill.

Low income assistance obviously is a desirable objective because heat is one of the necessities of life. I would be inclined to say, though, that it ought to be part of an overall program to assist low-income people, whether their needs are for medicine, medical treatment, drugs, or heat, what have you. That tends to strike me as being a requirement there, but obviously there are some people who can't afford it. We ought to help these people.

Senator WARNER. I would like to ease the passing of this legislation.

Mr. SIMONEAUX. I understand. I served in the legislature myself.

Mr. COLEMAN. Senator, no doubt, some type of assistance legislation would be helpful and I would agree with Mr. Lederer also, that there are middle-income people and businesses who are also hurt and being an energy commissioner, I would also point out that in a lot of assistance programs we tend to pour good money after bad in the sense that it does not take care of the retrofitting of houses, so any type of shaping of legislation I would think something about retrofitting would be very important.

Mr. O'CONNOR. Senator, as much as I strongly favor these kind of subsidy programs, and I wish they were better, I am somewhat disapproving that we make them as merely direct subsidy to an extremely inefficient natural gas supply system in this country. We should straighten out both problems.

Senator WARNER. Thank you.

Mr. LEDERER. Would I be permitted to add, if the Congress did want to put some money into helping the consumer, I think that more productive use of the money would be to help capitalize the clear customer demand for efficiency in the marketplace. And that is to help finance retrofits, insulation, and so forth.

That would be a productive use, and clearly help low income people, because it would lock them into efficient use for the long-term, and then lock the Government out of having to provide an open-ended assistance.

Senator WARNER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman,

First, might I say to you, Mr. Chairman, that I apologize for not having made previous hearings. I do not know how many of the later ones that I will be able to make, because of marking a project. But I commend you for moving expeditiously.

I do have just a couple of observations with reference to Senator Metzenbaum's yes or noes, that he asked the witnesses. I assume that one of the purposes of you having the hearings as extensive as you have had them and planned them is because it is the prerogative of the committee to modify the bill as presented by the President.

We do intend to do that, do we not, Mr. Chairman?

The CHAIRMAN. I can almost guarantee you that we will not start out by a yes or no vote on the bill.

Senator **Domenici**. I assumed that that would be——

Mr. **Lederer**. I would be in favor of that.

Senator **Domenici**. I assume that that would be the chairman's intention. I could ask the witnesses for a yes or no, if we could modify the bill in any way, so as to cause them to vote yes. And I assume that they would all say yes.

The **Chairman**. Senator Metzenbaum has encouraged me in that effort all along. He said his mind is not closed on it.

Senator **Domenici**. Excellent.

Senator **Metzenbaum**. It is pretty difficult to make a rose out of sow's ear.

Senator **Ford**. In addition, speaking of poetic justice, that is a purse. [Laughter.]

Senator **Domenici**. In addition, speaking of poetic justice, I recall when we first started with the natural gas prices, and we had a few States including the distinguished Senator's State that did not have any natural gas. I recall that you were not chairman yet, Senator McClure, but there was not any natural gas available in States like Ohio and a few others, Michigan.

Senator **Metzenbaum**. They were holding it back, Pete.

Senator **Domenici**. Yes, they were holding back. I assume that that was poetic justice, also, attributable to the crazy regulatory schemes that we had in existence at that time. But having said that, I want to talk just about one aspect with Mr. Simoneaux, because he does have a rather significant intrastate delivery system as well as an inter, and it is a very heavy consuming State, as I understand it.

Is that correct?

Mr. **Simoneaux**. That would be correct, Senator.

Senator **Domenici**. What portion of your delivery system is inter, and what portion intra?

Mr. **Simoneaux**. It has gotten up to 46, approximately, Senator.

Senator **Domenici**. Forty-six is what?

Mr. **Simoneaux**. Forty-six percent.

Senator **Domenici**. Is intra?

Mr. **Simoneaux**. Intra, yes.

Senator **Domenici**. In terms of consumption, does Louisiana consume a lot of natural gas?

Mr. **Simoneaux**. I am sorry.

Senator **Domenici**. Are you a big consumer?

Mr. **Simoneaux**. Oh, yes. In terms of consumption volume-wise, we are not on the top; but on a per capita basis, we are number 1, and substantially ahead of number 2.

Senator **Domenici**. I note that we have had witnesses indicate, and some questioning indicating that there is concern about the intrastate pipelines gaining some competitive advantage under this bill.

Do you believe that this is so?

Mr. **Simoneaux**. No, we do not see it. The intrastate pipelines are either at or slightly above market clearing prices. Our intrastate pipelines do not have the low cushion gas. They were the ones who got on this 107 deep gas and other costly gas, and simply ran up against a ceiling. And I am talking about the market ceiling.

So our intrastate pipelines are not in a position to out bid interstate lines, and would not be under this bill.

Senator DOMENICI. So the purchased gas adjustment limitation bill, in your opinion, does not need to be placed on the interstate pipeline through January 1, 1986, as it does for the intrastate?

Mr. SIMONEAUX. No. If the fear is that our intrastates ought to be put under that provision because it may take away interstate supplies, then there is absolutely no basis for that. As a matter of fact, our problem in Louisiana has been that our intrastate lines have been hurting because of the high average cost of gas.

Senator DOMENICI. And I take it that it would be your position that the intrastate lines would be placed at a competitive disadvantage to bid for new gas, if we do not decontrol 104 gas that provides a cushion to the interstate pipelines, is that correct?

Mr. SIMONEAUX. Yes, that would be correct, yes.

Senator DOMENICI. And would you just elaborate, and give us a little more reasoning on that?

Mr. SIMONEAUX. Well, the disadvantage that our intrastate lines are under is that fact the interstates for years have had a large volume of low priced gas. So with this reserve of a large volume of low priced gas, they are able then to go in the market under the NGPA, and bid up deregulated gas at a much higher price than the actual value that the gas would be under any market, except under this distorted market of the NGPA.

So that is the basis of the advantage of the interstates.

Senator DOMENICI. Thank you.

Thank you, Mr. Chairman.

Mr. SIMONEAUX. And incidentally, we take a broad view that we do not want to favor intra or inter. We want everyone to come down from the extremes, and come down somewhere towards the center, so that you can establish some very representative value of gas.

Senator FORD. Including FERC jurisdiction for all?

Mr. SIMONEAUX. It is unnecessary.

Senator FORD. But I said but you want everybody to be treated the same.

Do you want FERC jurisdiction of intrastate?

Mr. SIMONEAUX. If there was some basis in order to bring intrastates, if the intrastates had an advantage, then you might argue that. But they do not, and they will not under this bill, Senator.

The CHAIRMAN. We have had some questions and some comments about the development of a dual market system. And I think that we need to look at that. Whether or not this bill tends in that direction, or tends away from the direction, if one is established now.

But I think that Mr. O'Connor touched on one of the questions that is of concern to many in that regard. And that is do you convert the pipelines into common carriers, or contract carriers. And there is a provision in the bill, as has been pointed out, that moves in that direction.

One of the questions that we have to ask ourselves when we do that is whether or not if it does not reach the intrastate pipeline, do we further the dual market system that might develop.

Now is that a sufficient concern to people at this table to lead you to conclude that any such provision needs to apply to both interstate pipelines and intrastate pipelines? Ms. Murrell.

Ms. Murrell. I have not thought about that.

Can I supply an answer for the record?

The Chairman. Yes, if you would, please.

Mr. Lederer.

Mr. Lederer. I think that the problem of the obstacle in the marketplace is an economic problem, and not a jurisdictional problem that should apply.

The Chairman. I am sure that that is correct. But we have two different regulatory systems.

Mr. Lederer. I appreciate that. I think that the ability of the buyer to have a purchaser supply and have it transmitted should be, I think, be facilitated whether the supplier is intrastate or interstate.

I personally, as I have said in my statement, find the State level regulation generally more effective for other reasons. And I would not like to see the common carriers type proposal be viewed as an opportunity for FERC preemption of the State level.

There is one other way that it might be approached. And that is if the Congress felt that the common carrier status of going all the way on it had certain problems, then at least the average pricing mechanism that the pipelines are using now to meld various different costs of supplies probably should be prohibited.

So that whatever gas that they are selling is sold at the cost of that particular gas. That would at least give the marketplace some opportunity to reject high cost gas.

The Chairman. Mr. Simoneaux.

Mr. Simoneaux. I have already stated essentially that we do not believe that there will be a dual market under this bill. The intrastates right now do have a higher cost gas. The interstates are the ones that are generally in place for the more favorable fuels.

And as we all know, there is a great inclination among business people to continue the business relationship that exists. They know each other, and they understand each other's needs, and their practices, the fields, the reserves, or what have you.

So an intrastate line has a great deal of impetus to continue with the current producers, even under this bill that provides for renegotiation or market-out clauses. So the intrastates would not have that advantage, it seems to me. There may be some slight disadvantage.

But we do not see any basis for putting the intrastates under the FERC jurisdiction on a complete basis.

The Chairman. Mr. Coleman.

Mr. Coleman. Sir, you raised a question that we have not taken up in the State of New Jersey. So I will beg off.

The Chairman. If you would like to submit an answer to that question, you may.

Mr. Coleman. We would be happy to.

The Chairman. Mr. O'Connor.

Mr. O'Connor. Mr. Chairman, under a common carrier proposal for pipelines, it is my feeling that first of all a national market would develop, so that the dual market would fade away rather quickly. But to the extent that you have intrastate pipeline activity, it would be my sense that that would more appropriately, the rate of return that would have to be developed for them and the tariffs, it would probably be better to make them common carriers under State regulation. It would probably be a little more efficient, and make more sense.

The CHAIRMAN. You would like to have the intrastates regulated by the States in spite of the national market?

Mr. O'CONNOR. Well, I would not——

The CHAIRMAN. When you are talking about making them common carriers, you are talking about only the intrastate pipelines?

Mr. O'CONNOR. In our proposal, all that is necessary really to begin really solving this problem is to have an interstate system become common carrier. If you went that way, though, it would not be long before intrastate pipeline systems would end up being common carriers and get a fair rate of return under their State regulation.

The CHAIRMAN. Senator Ford.

Senator FORD. Thank you, Mr. Chairman.

This is one thing that has disturbed me for a long time. And Senator Domenici has struck on it. And I have been asking questions all this week as it relates to this dual situation. We found that intrastate was charging more and getting more than interstate when we finally put the Natural Gas Policy Act into place, and we got intrastate into interstate, and gave those consuming States an opportunity, because we were shut out.

And Mr. Butler, if you were here, Mr. Simoneaux, and I am sure you were, testified, and he is the Chairman of the Federal Regulatory Commission, that on January 1, 1985, that we would have a dual system. He testified to that just earlier that we would have a dual system on January 1, 1985.

And since this is my concern, Mr. Chairman, I want to put my concerns into the record, and would like to make a brief statement. Under S. 615, provision is made that for all existing contracts not regulated before January 1, 1985, the purchaser or seller have the right to terminate such contract.

Additionally, the bill provides a lid on the costs that an interstate pipeline can flow through to its customers equal to its average cost at the time of enactment plus an inflation factor after January 1, 1986.

Thus, this interstate pipeline will be restricted in its ability to renegotiate its old gas contracts or any new gas contracts due to the flow through lid. Therefore, a dual market will exist from the date of enactment. It is probable that a significant number of old contracts cannot be negotiated by January 1, 1985, and thus be terminated on that date, and the producer seek new buyers.

At the critical date, January 1, 1985, that is the critical date, a dual market will exist under this legislation, because the interstate pipeline will be restricted by the lid, while the intrastate or direct user purchaser will have no restrictions.

It is true that the dual market would cease on January 1, 1986. However, between January 1, 1985 and January 1, 1986, significant gas reserves will potentially be redistributed from the interstate to the intrastate pipelines under this legislation as now drafted.

I will have some solutions, Mr. Chairman, to recommend to this committee, if we ever get to it.

The CHAIRMAN. Mr. Simoneaux.

Mr. SIMONEAUX. Very briefly. Senator Ford, the only response that I would have would be that I think that the intrastate pipelines would be delighted to switch places with the interstate pipelines, and have the low cost gas that the interstates have. I think that they would like to change places. So the point that I am making is that they——

Senator FORD. That is the very point that I am making. That is the very point that I am making for interstates. I am a consumer, and that is the very point that I am making. You are supporting my case very adequately, Mr. Simoneaux.

Mr. SIMONEAUX. You see, the interstate lines because of the low cushion are the ones that are going to have prices to increase. The intras are already out of the market as a practical matter. So they will not be able to go any higher to passthrough any more prices. That is why there is no reason to put them under the same passthrough requirements.

Senator FORD. On January 1, 1985, Mr. Simoneaux, that is the date that triggers the intrastate. And all they have to do is bid a little above the cap, and they have got it, and the interstates lose it, and you break the contract.

Mr. SIMONEAUX. To whom do they sell it to, Senator, if they are above the market value?

Senator FORD. Who were you selling it to before we put this particular law into place?

Mr. SIMONEAUX. The point made——

Senator FORD. It is old gas that we are talking about, not new gas. We are talking about old gas.

Mr. SIMONEAUX. Old gas. But the point being that if they buy it, and they are above the market value of the gas, no one will buy it from them.

Senator FORD. Yes, they will.

The CHAIRMAN. Thank you, very much. I appreciate the testimony, and I will look forward to the responses to the written questions that may be submitted to each of you. I look forward to that response. Thank you.

We next move to panel No. 2. John H. Croom, president, Columbia Gas System; Mr. Wayne Johnson, president of Entex; Mr. O. C. Davis, chairman of Midcon Corp.; and Mr. John Abram, chairman, Southern California Gas Co.

Gentlemen, as you know, with previous witnesses, we have filed their written statements. The same will be applied with respect to your testimony.

In view of the hour, I am sure you understand the need for some time constraint. If you can summarize your position in 5 minutes.

Mr. Croom.

STATEMENT OF JOHN H. CROOM, PRESIDENT, THE COLUMBIA GAS SYSTEM, INC.

Mr. CROOM. Thank you.

Mr. Chairman and members of the committee, my name is John H. Croom. I am president of the Columbia Gas System, a major supplier of natural gas to some 4.2 million customers in 18 Eastern States and the District of Columbia.

Columbia is deeply concerned about the already high level of natural gas prices and the continuing increases to consumers, and appreciates this opportunity to express our views to the committee.

Columbia has sought to stabilize or reduce prices by private negotiations with producers. Since July 1982, we have aggressively sought relief from the take-or-pay obligations with southwest producer/suppliers. Some relief has been gained, but not enough.

We have also attempted to negotiate price reductions and the elimination of indefinite price escalators and high-cost gas purchased contracts with southwest producers.

To date, these efforts have not been successful. Columbia believes that under current circumstances prices will continue to escalate. If nothing else the automatic inflation adjustments with so-called growth factors for newer gas under NGPA will inevitably push average gas prices higher.

Even with renegotiated contracts, prices will also increase because of the operational latitude claimed by producers under contracts covering more than one price category of natural gas.

Under these contracts, the notice to reduce total deliveries may result primarily in a reduction of old gas, thereby increasing the percentage of higher priced gas.

This refusal of producers to spread cut-backs evenly over all categories of gas increases the average cost of gas.

This kind of increase would be prevented by a section of the administration's bill 615, which states that—and I quote.

"Any contract establishing two or more categories of natural gas for purposes of pricing the natural gas delivered under contract shall be treated under separate contracts for each such category."

End of quote.

Despite this particular provision, we do not believe that S. 615 will, in fact, provide consumers with prompt price relief.

In brief, S. 615 does not put enough incentive on producers with high-cost contracts to negotiate lower price levels, while it gives producers of low-cost gas too much flexibility to obtain higher prices.

Some specific flaws are these:

The 70-percent ceiling on take-or-pay should be lowered to 50 percent.

S. 615 would deregulate all gas, including so-called old gas. However, the deregulation of any gas not planned to be deregulated under the NGPA, including old gas would unnecessarily raise the price to consumers.

S. 615's broad imposition of statutory market-outs to all gas would have the same adverse impact on customer prices as the broadening of deregulation.

Market-out should be limited to gas which is presently deregulated, and gas which will become deregulated under the NGPA, not old gas.

We also believe the market-out provision should be effective immediately as in S. 689 introduced by Senator Heinz, which we believe has considerable potential.

Beyond these reservations, we believe that if S. 615 and any other legislation to deal with gas prices should include certain principles which Columbia has set forth in its prepared and previously submitted testimony.

Senator Heinz's S. 689 focuses directly on the fundamental problem involved—inflexible contract provisions. We recommend, however, that S. 689 include language to address the problem of contracts containing more than one price category, as in the administration's bill.

If enacted with this amendment, S. 689 could result in needed price reductions in contrast to probable price increase under S. 615.

Thank you for this opportunity to reflect on these views.

The CHAIRMAN. Thank you very much, Mr. Croom.

[The prepared statement of Mr. Croom follows:]

Prepared Statement
of
John H. Croom
President, The Columbia Gas System, Inc.
Before the
Senate Committee on Energy and Natural Resources
March 12, 1983

My name is John Croom. I am President of The Columbia Gas System, Inc. Columbia is a major supplier of natural gas to consumers in eight eastern states including Ohio, Pennsylvania, Virginia, West Virginia, Kentucky and the District of Columbia. As such, I consider my testimony today to be on behalf of the 4.2 million customers served through the 71 local utilities which Columbia supplies. Because Columbia owns and operates eight distribution utilities, I know firsthand the problems residential consumers are having with rising gas costs. I also know the difficulties imposed on business and industry by rising gas costs. Columbia's interests in the transmission and distribution segments of the industry are closely involved in the current pricing problem, but unless legislation serves the interests of these consumers, there will be little ultimate benefit to the gas pipeline and distribution companies. Moreover, unless our customers believe that the long-range outlook is for the price of natural gas to be competitive with other sources of energy, serious detriment to the entire natural gas market and to the energy future of the country are in the offing.

Columbia is deeply concerned about the increases that are occurring throughout the nation in natural gas prices and appreciates this opportunity to work with the Senate Committee on Energy and Natural Resources on this serious matter. Unless legislative action is taken, natural gas prices will continue to increase. Our recommendations are in the consumers' interest and will help hundreds of thousands of people avoid hardship they would otherwise experience.

Columbia's Price and Supply Projections

To put into perspective the views I will present on legislation, I will briefly review Columbia's current outlook. Natural gas supplies available to Columbia in 1983 and 1984 will far exceed our requirements. Our cutbacks of supply in 1983 may exceed 600 billion cubic feet of available supply with requirements estimated to be in the vicinity of 950 billion cubic feet; 1984 requirements probably will be comparable. These levels assume no improvement in the economy. Estimates of take-or-pay exposure could run into hundreds of millions of dollars.

Under current circumstances prices will continue to escalate. If nothing else, the automatic inflation adjustments with so-called growth factors for newer gas, as provided by N.G.P.A., will inevitably push average gas prices higher. As of March 1, 1983, the average cost of gas underlying Columbia's rates is approximately $4.07 per MMBtu, and by September, 1984, is projected to be $5.41 per MMBtu under current conditions.

Prices will also increase because of the latitude claimed by producers under contracts covering more than one NGPA price category of natural gas. Under these contracts, a notice to the producers to reduce total deliveries may result primarily in a reduction in deliveries of old gas, thereby increasing the percentage of higher priced gas delivered. This refusal of producers to spread cutbacks evenly over all categories of gas increases the average price of gas. The effect of such practice on our gas costs is shown on Attachment 1. This kind of increase would be stopped by a provision in the Administration's Bill S. 615 which states that "any contract establishing two or more categories of natural gas for purposes of pricing the natural gas delivered under the contract shall be treated as separate contracts for each such category".

Columbia's Efforts to Renegotiate Producer Contracts

In July, 1982, Columbia initiated an intensive effort to negotiate its take-or-pay obligations with its southwest producer/suppliers down to a 75% of deliverability level. Producers representing some 60% by volume of our 1982 winter southwest producer purchases have agreed either to amend their contracts with Columbia so as to reflect a 75% take-or-pay level or to waive take-or-pay obligations above that level. Although negotiations are continuing, we do not expect many more new agreements. Attachment 2 lists producers which have agreed to reductions or waivers; Attachment 3 lists those producers which have not. There is some duplication because of multiple contracts.

With respect to high-cost gas purchase contracts, we met with southwestern producers selling us deep gas and by letter proposed a reduction in price to $5 per MMBtu and the elimination of indefinite price escalators for price renegotiation in 1985. So far, gas producers have responded negatively. Attachment 4 is the form of letter sent.

Columbia has also contacted a number of independent Appalachian producers selling it N.G.P.A. Section 107 "tight sands" and deregulated Devonian shale gas and proposed a price of $4.50 per MMBtu instead of the current "tight sands" incentive price of $5.46 per MMBtu with a redetermination to market rates in 1985. We may be able to negotiate reductions on a large portion of these purchases.

We have already reduced the prices charged by our production affiliates to the above noted levels for deep gas and "tight sands" gas.

Columbia has also refused to pay minimum bills relating to gas not taken from its southwest pipeline suppliers.

Most recently we have begun formal notification to producers in the southwest which are still drilling for deregulated gas on acreage committed by contract to us. The notices advise that Columbia will not accept increased deliveries resulting from such new wells.

Legislative Proposals

Millions of natural gas consumers throughout the country have serious problems today because of price. These consumers, especially senior citizens and disadvantaged poor, may well have even more difficult problems tomorrow unless protective steps are taken now by Congress. Columbia has already taken some major steps as I've just described, but as our experience shows much more, far beyond what an individual company can do, needs to be accomplished.

A number of legislative proposals have been made on ways to deal with the serious natural gas price situation. Before detailing the legislative action which we believe is necessary, I think it important to give this Committee our views on S. 615--the President's proposed Natural Gas Consumer Regulatory Reform Bill. As written, this would change many aspects of natural gas pricing and attempts to provide a transition toward producer price deregulation. By so doing, it purports to provide lower prices to consumers. In our opinion, however, this will not happen in the near-term because S. 615 has a number of basic flaws.

S. 615 would deregulate all gas, including so-called old gas which under the N.G.P.A. would be forever regulated. Columbia opposes deregulation of any gas not planned to be deregulated under the N.G.P.A. because this would unnecessarily raise the price to consumers.

Columbia also opposes the broad imposition of statutory market-out provisions in S. 615. Such provisions would have the same adverse impact on customer prices as the broadening of deregulation. The market-out provisions in S. 615 are so broad that they would give intrastate pipelines and industry in the producing states a hunting license to go after reserves now dedicated to the interstate market. Statutory market-out provisions should be limited to gas which is presently deregulated and gas which will become deregulated under the N.G.P.A. (not old gas). We also recommend that market-out provisions should be made effective immediately, as provided in S. 689 introduced by Senator Heinz on March 3.

S. 615 would impose a limit on take-or-pay provisions at 70% of gas availability. Columbia believes take-or-pay in all contracts, and for all pricing categories of gas, should be limited to 50% of gas available for three years instead of 70% as proposed in the President's Bill. This lower percentage would provide more meaningful flexibility for the pipeline, yet recognize minimum cash flow needs of the producer.

The theory of S. 615 is that high gas prices will go down and lower gas prices will go up so that market-clearing balances will be achieved. The Bill, however, does not put enough pressure on producers with high-cost contracts to negotiate to lower price levels, while it will be easy for low-cost contract producers to get higher prices. This brings up the extremely restrictive pass-through which, coupled with the other provisions of S. 615, could result in bankruptcy for pipelines.

I have also examined S. 689 by Senator Heinz, to which I referred earlier. In my opinion, this Bill focuses directly on the problem facing consumers and the gas industry--the intractable provisions in producer contracts which do not permit the price of gas to respond to market conditions. However, I think it would be imperative to add to the Heinz Bill a provision requiring that contracts covering more than one price category of gas should be considered as separate contracts. This seems to be essential, not only for the reason I have mentioned in my testimony, but in order to make market-out and take-or-pay provisions work as intended. With this change, S. 689's limitations on price escalations, its take-or-pay limitations, its market-out provisions and its continued regulation of old gas would provide substantial benefit to consumers.

While we believe most of the provisions of S. 689 are positive and address the problems facing consumers today, we do not agree with the rate increase disincentive.

Based on Columbia's experience in dealing with producers in seeking to renegotiate contracts, we believe the following legislative action is needed:

1. Take-or-pay clauses in existing contracts should be rolled back to 50% for 3 years.

2. Any contract establishing two or more categories of natural gas for purposes of pricing natural gas delivered under the contract should be treated as separate contracts for each such category.

3. Escalator clauses should be limited in all existing contracts by a floating cap reflective of current market conditions.

4. Third party most favored nation clauses in all contracts should be permanently banned.

5. There should be a one-time market-out for all presently deregulated gas and all gas to be deregulated under N.G.P.A. Such market-out would include a one-time bilateral (i.e., either party unilaterally) termination option for pipelines and producers within 12 months.

6. Any purchaser who exercises a statutory market-out or a statutory take-or-pay limitation to reduce its takes shall provide transportation of any volumes of natural gas involved in such reduction; and

7. No preferential treatment shall be given to affiliated production either with respect to volumes or price for like categories of gas during the time a statutory take-or-pay provision is being exercised.

Prompt legislative action to achieve these conditions in contracts between producers and pipelines is essential to stop the steady upward climb in consumer gas costs.

I appreciate this opportunity to present Columbia's views to this Committee.

Attachment 1

COLUMBIA GAS TRANSMISSION CORPORATION

Comparison of Estimated Southwest Gas Purchases Before and After Caps by NGPA Sections

(March 1, 1983 through August 31, 1983)

NGPA Section	Full Deliverability Mcf (1)	Estimated Purchases Mcf (2)	Difference (3) (1)-(2)	Percent Cut (4) (3)÷(1)
Optional Pricing	5,571,478	3,136,323	2,435,155	43.7%
102	136,180,862	113,470,370	23,710,486	17.3%
103	34,758,256	18,853,620	15,904,636	45.8%
104	105,964,162	52,260,850	53,703,312	50.7%
105	-	-	-	-
106	2,883,486	1,782,880	1,100,606	38.2%
107	-	-	-	-
107TG	56,422,175	41,835,013	14,587,162	25.9%
108	786	786	-	-
109	858,523	573,258	285,265	33.2%
Total	[illegible]	[illegible]	[illegible]	[illegible]
Average Price	$3.765	$4.171	0.376	

Attachment 2

Producers Which Have Agreed to Reductions or Waivers

American Quasar Petroleum Co.
Cities Service Company
B. E. Cobb
Cobb Brothers
Coltexo Corporation
ENI
Forest Oil Corporation
Hadson Petroleum Corp.
Hanna Oil & Gas Co.
Hawkins Oil & Gas, Inc.
M. L. Mayfield
Thomas C. Mueller
John P. Shields
Stephens Drilling Co.
Stephens Production Co.
Samson Resources Company
Southern Resources, Inc.
Sun Exploration & Production Co.
Towner Petroleum Company
Westland Exploration Company
Westphal Oil & Gas Co.
Robert B. Westphal
Whitman Exploration Company
George William Woods, et al.
Columbia Gas Development Corp.
Union Texas Petroleum
Exxon Corporation

In addition to the above amendatory agreements, letters waiving enforcement of take-or-pay provisions have been received from the following producers:

Shell Oil Company
Amoco Production Company

Attachment 3

PRODUCERS WHICH AS OF THIS DATE HAVE NOT EXECUTED A SEVENTY-FIVE PERCENT TAKE-OR-PAY AMENDMENT

(A) Adobe Oil & Gas Corporation
J. D. Alexander
Alminex U.S.A. Inc.
Amerada Hess Corporation
American Independent Oil Company
American Petrofina Company of Texas
Amoco Production Company
Andover Oil Company
The Anschutz Corporation
Apache Corporation
Arco Oil & Gas Company
Aspen Exploration

(B) H. W. Bass & Sons, Inc.
Perry R. Bass
Phillip B. Berry
Bethlehem Steel Corporation
Bledsoe Energy Corporation
Brock Exploration Corporation
Charles D. Browder
Betty Brown Bryan
Earl P. Burke, Jr., *et al.*
Allen D. Burris

(C) Cabot Corporation
Callery Properties, Inc.
Canso Oil & Gas, Inc.
Case-Pomeroy Oil Corporation
Chapparal Resources
Chevron U.S.A., Inc.
Clark Resources, Inc.
CNG Producing Company
Coleve
Conoco, Inc.
Coquina Petroleum, Inc.
Cotton Petroleum Corporation
Edwin L. Cox
Crouch Petroleum
Crystal Oil Company

(D) Depco, Inc.
Devon Energy Corporation
Dome Petroleum Corporation
Dyco Petroleum Corporation

(E) Edgewater Oil Company, Inc.
Robert E. Eberly, Sr.
Energy Leasing Services
Energy Reserves Group, Inc.
Ennex, Inc.
Ensource, Incorporated
Enstar Petroleum, Inc.
Essex Exploration, Inc.
Ethyl Development Corporation
Exchange Oil & Gas Corporation

(F) Felmont Oil Corporation
Four M Properties, Ltd.
Franks Petroleum Inc.

(G) Galaxy Oil Company
Geo-Dynamics Oil & Gas, Inc.
General American Oil Company of Texas
Geological-Geophysical Associates, Inc.
Grace Petroleum Corporation
Graham Exploration, Ltd.
Great Southern Oil & Gas Co., Inc.
Gulf Oil Corporation

(H) Hadson Ohio Oil Company
Hadson Petroleum Corporation
Hamilton Brothers Oil Company
Hanley Petroleum, Inc.
HNG Oil Company
Home Petroleum Corporation
J. M. Huber Corporation
Roy M. Huffington, Inc.
Hydrocarbon Exploration Company, Inc.

(I) ICI Delaware Inc.
Imperial American Management Co.
Inexco Oil Company

(J) Jones-O'Brien, Incorporated

(K) Kaiser-Francis Oil Company
Keota Mill & Elevator
James H. Kepper, Jr.
Koch Industries, Inc.

(L) Lamark Energy, Inc.
Louisiana Land & Exploration
Lamson/Onshore Petroleum
Mr. Hugh E. Ledbetter

(M) Marlin Oil Corporation (Houston)
Marlin Oil Corporation (OK City)
McAlester Fuel Company
McMoran Exploration Company
MCOR Oil Development
Mesa Petroleum Co.
Mid-Continent Supply Company
Mid-Gulf Exploration Company
Miles Kimball Company
Mobil Oil Corporation
James R. Moffett
Mono Power Company
Monsanto Company
Montgomery Exploration
Moore-McCormack Oil & Gas Corporation
J. Hiram Moore, Ltd.
Moran Exploration, Inc.
Robert Mosbacher
Munn Exploration Company, Inc.

(N) National Oil Company
Natresco, Inc.
Newmont Oil Company
Northern Michigan Exploration Company
The Northwestern Mutual Life Ins. Co.

(O) Odeco Drilling, Inc.
Odeco Oil & Gas Company
Olin Corporation
Oxley Petroleum Company
Oxy Petroleum, Inc.

(P) Panacanadian Petroleum Company
Pelto Oil Company
Petro-Lewis Corporation
Petro-Lewis Funds, Inc.
Phillips Petroleum Company

(Q) Quintana Petroleum Corporation

(R) Rebel Oil Company
Rebstock Producing Company
Reeves Producing Company
Regency Exploration, Inc.
Riner Exploration Corporation

(S) St. Joe Petroleum (U.S.) Corporation
P. D. Sams & Company
Samson Resources Company
Santa Fe Energy Company
Service Drilling Company
Shell Oil Company
Jay Simmons Trust
Southern Resources, Inc.
Southport Exploration, Inc.
Southwestern Exploration
The Stone Oil Corporation
Strata Energy, Inc.
Struthers Oil & Gas Corporation
The Superior Oil Company

(T) Tenneco Exploration, Ltd.
Tenneco, Inc.
Tesoro Petroleum Corporation
Texaco, Inc.
Texas Eastern Exploration Co.
Texas Gas Exploration Corporation
Texasgulf, Inc.
Texas International Petroleum
Texas Pacific Oil Company
Transco Exploration Co.
TXO Production Corporation

(U) Union Oil Company of California (Houston)
Union Oil Company of California (Midland, TX)
Unit Drilling & Exploration Company
United Petroleum Resources, Inc.

(W) W. W. F. Oil Corporation
Wagner & Brown, et al.
Watson Oil Corporation
Curt Weaver
Westland Exploration Company
Windsor Gas Corporation
The Wiser Oil Company

COLUMBIA GAS
Transmission

Attachment 4

P. J. D'Agostino
Senior Vice President

December 28, 1982

Attention:

Dear Mr.

This letter is in reference to the meeting of December 7, 1982, at which and representatives of Columbia and certain of its customers discussed the difficulties being experienced by Columbia and its customers in marketing gas. Columbia appreciates that opportunity to exchange information.

The purpose of this letter is to follow up on those discussions by proposing two changes in the gas sales and purchase agreements between your company and Columbia so as to assist Columbia in once again becoming a viable and aggressive marketer of your gas.

First, Columbia proposes a reduction in the price for all Section 107 deep deregulated gas sold by your company to Columbia from its current rate to $5.00 per MMBtu effective January 1, 1983. Based upon the recent actions of other pipelines in exercising "market-out" clauses, this rate approximates today's market price for Section 107 gas and is currently required to assist Columbia in achieving the goal of making Columbia's gas marketable to marginal industrial loads again.

Second, Columbia proposes that the escalation provisions pertaining to deregulated gas found in the above contracts be deleted effective January 1, 1983 and replaced by provisions which permit either party to request price renegotiations at intervals no more frequent than every two years to achieve the then current market levels. Under this proposal, if the parties could not agree upon an appropriate price for the gas, then the Seller could solicit offers for it and, if the purchaser was unwilling to meet the highest bona fide offer, the gas would be released. This proposal will make gas pricing responsive to the marketplace and will protect both Buyer and Seller. Thus, it is equitable to both sides.

Columbia Gas Transmission Corporation, 1700 MacCorkle Ave. S. E.,P.O. Box 1273
Charleston, West Virginia 25325, Tel. (304) 346-0951

As Columbia mentioned at the meeting, it is imperative that these contracts be renegotiated. At present the gas market is in turmoil because the price for gas is outstripping competitive fuels by such a margin that gas cannot and will not in the future be able to compete for many markets. This continuing erosion of the market works to the ultimate detriment of both your company and of Columbia: In Columbia's case because its very existence is threatened and in your company's case because the markets for your product are being lost.

The only solution is for all parties to cooperate so as to reduce the price of gas to the ultimate consumer. If this is not achieved by voluntary means, Columbia believes that government action is the likely result. Indeed, as a matter of survival many gas companies are already beginning to seek government intervention even though it may be contrary to the individual philosophies of their executives to do so. As the situation worsens, the urge to adopt this course of action will become increasingly difficult to resist.

Government intervention can be avoided and market erosion halted if the industry demonstrates that gas prices will respond to fluctuations in the marketplace. Constant price increases in the face of a soft market only supply ammunition to those who claim that the gas industry does not respond to the laws of supply and demand because of its monopolistic nature and, therefore, assert that it must be forever regulated. Prompt action demonstrating that the industry can and will respond is required both to rebut these allegations and arrest the erosion of gas' competitive position.

Columbia is very anxious to pursue the proposals contained herein. Please give them your careful consideration. A representative of Columbia will be contacting you soon towards establishing future dates and times when these and other possibilities can be explored further.

Very truly yours,

The CHAIRMAN. Mr. Johnson.

STATEMENT OF WAYNE D. JOHNSON, PRESIDENT, ENTEX, INC.

Mr. JOHNSON. Mr. Chairman and members of the committee.

I appreciate the opportunity to appear before you today and to summarize the more complete testimony which I have previously supplied to the committee.

My name is Wayne Johnson. I am president of Entex, which is the fifth largest gas distribution utility in the United States, serving in excess of 1.25 million customers in the States of Texas, Louisiana, and Mississippi.

We buy gas from 26 different pipeline suppliers and producers. Of the total gas purchased approximately 70 percent is purchased from intrastate pipelines, and 30 percent from interstate pipelines.

Because we are dependent upon both intrastate and interstate pipelines, it is in our very strong interests that congressional action affecting natural gas field prices treat both intrastate and interstate pipetines equitabty.

In my testimony today, I would like to make four points.

One, we believe that the EPA has confused the entire marketplace with resulting injury to producers, pipelines, distributors and consumers.

Two, we believe that the chaos produced by a combination of NGPA induced confusion, plus the recession and an oil glut has begun to create a market environment in the gas industry, and that now is the time to decontrol natural gas field prices, specifically including the controls on old gas.

Three, although, we prefer complete decontrol, we believe that a compromise between the partisans of complete decontrol and of the status quo is highly desirable.

Four, we believe that S. 615 in its present form is not an acceptable compromise.

I will go back to the first point, if I may. That the NGPA has badly confused the marketplace.

Entex has been a consistent supporter of immediate and total decontrol of natural gas field prices for many months. I have testified to that effect before the Sharp subcommittee and before numerous other bodies.

Since we remain a strong supporter of complete decontrol, I will not, in the interest of time, reiterate the rationale for our view, which is set forth in my complete testimony before this committee.

Our second point—that the chaos produced by a combination of NGPA induced confusion, a recession, and an oil glut has begun to create a free market. I think very few people outside the natural gas industry understand that the industry is currently in a highly chaotic state.

The principal reason is the confusion created by 4 years by a half controlled, half free environment under the NGPA.

Despite the confusion, it is important to notice what is beginning to happen. Despite the old gas cushion, free market at the wellhead is actually beginning to develop. Both interstate and intrastate pipelines are reducing the price they are willing to pay, particularly for deep and tight gas, and generally to market-clearing levels.

Purchasers who can offer producers high takes can now buy new gas below the 102 price, a result which would have been unthinkable only 1 year ago. The explanation for this recent rationality at the wellhead is simple. The free market has begun to work. The wellhead price has got so high that very sizeable markets were lost.

In many cases these load losses reflect permanent structural changes which are the direct result of high field prices. Not so permanent but equally as damaging has been the loss of substantial loads to oil. For all practical purposes oil products now trade in a free market.

The free market in oil is spreading into gas markets whether we like it or not. It is our judgment that pipelines now have ample incentive to bargain effectively with producers.

For the first time in memory, our company has received a reduction in gas prices from both of the intrastate pipelines, from whom we purchase gas in Houston, and we expect this trend to continue for at least the next several months.

We think it is important that the environment presently be cleared and that it be cleared by deregulation. We think it is important to provide producers with certainty that a free market will prevail and to get them to go back to drilling, because we are now looking at a situation in which reserves are being depteted, and despite the current gas glut new reserves will not be present when we need them most.

I emphasized before that we are willing to compromise. I think the general outlines of the compromise are specified in my testimony, and I will not repeat them at this time.

We do believe that S. 615 in its present form is not an acceptable compromise, and I have specified five reasons in my testimony why we are of that opinion.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Johnson.

[The prepared statement of Mr. Johnson follows:]

TESTIMONY
WAYNE D. JOHNSON
BEFORE THE
COMMITTEE ON ENERGY & NATURAL RESOURCES
UNITED STATES SENATE
MARCH 12, 1983

My name is Wayne D. Johnson. I am President of Entex, Inc., a Texas corporation with its principal office at 1200 Milam, Houston, Texas. Our mailing address is P. O. Box 2628, Houston, Texas 77001.

Entex is the fifth largest gas distribution utility in the United States serving in excess of 1,250,000 customers in the States of Texas, Louisiana and Mississippi. Approximately 975,000 customers are located in Texas, 130,000 in Louisiana and 100,000 in Mississippi. Houston is the largest metropolitan area served by Entex.

Entex is also engaged in other activities in the energy field which are not related to its utility operations. Through its Big Chief Drilling and Comet Drilling subsidiaries, Entex owns and operates 27 land-based drilling rigs in Oklahoma, Louisiana and California. We also engage in oil and gas exploraton and production and are currently investing approximately $35,000,000 per year in these activities; with very minor exceptions, we do not sell gas produced from our own wells to our distribution utility operations. Entex also owns significant lignite reserves in Texas and Mississippi.

In addition, Entex owns 100% of University Savings Association, the third largest savings association in Texas with assets of approximately 2.5 billion dollars. Miscellaneous other activities include specialty refining, production of roofing materials and manufacture of communication security equipment.

Entex believes that it may have a somewhat unique perspective on the Natural Gas Policy Act (NGPA). Entex purchases gas from 26 pipeline suppliers and producers. Of the total gas purchased by us for resale, approximately 70% is purchased from intrastate pipelines and 30% from interstate pipelines. Geographically, our Houston, Texas Coast, Beaumont and South Texas Divisions are primarily dependent on intrastate gas; our East Texas, Louisiana and Mississippi Divisions primarily rely on interstate gas.

Because we are dependent on both intrastate and interstate pipelines, it is in our very strong interest that Congressional action affecting natural gas field prices treat both intrastate and interstate pipelines equitably. Just as important is our very strong interest in being able to purchase gas from all our pipeline suppliers at prices which will allow us to sell gas to our customers at reasonable and competitive rates. In the latter respect, I believe our interest is essentially the same as that of all other pipelines and distributors in this country.

Although we share a common objective with other gas distribution companies, I suspect that Entex probably has its own perception of the problems which the NGPA presents and of the best way to go about sovling those problems. In my testimony today, I would like to stress four points:

- One, we believe that the NGPA, which establishes a wide range of prices for an essentially fungible commodity, has confused the entire marketplace with resulting injury to the producers, pipelines, distributors and consumers.

- Two, we believe that the chaos produced by a combination of NGPA-induced confusion, a recession and an oil glut has begun to create a market environment in the gas industry and that now is the time to decontrol natural gas field prices, specifically including the controls on old gas.
- Three, although we prefer complete decontrol, we believe that a compromise between the partisans of complete decontrol and of the status quo (or perhaps even recontrol) is highly desirable.
- Four, we believe that S. 615 in its present form is not an acceptable compromise.

Let me elaborate on each of these points.

1. THE NGPA HAS BADLY CONFUSED THE MARKETPLACE WITH RESULTING INJURY TO PRODUCERS, PIPELINES, DISTRIBUTORS AND CONSUMERS.

Let me begin by pointing out that for all practical purposes, gas is a fungible commodity. That is to say, one Mcf of gas is essentially identical to all others. In a free market, fungible commodities trade at a uniform price except for minor differences in quality, location and other unique characteristics. The best indication of the confusion in gas markets created by the NGPA is the gross variation in prices which prevailed for an essentially fungible commodity. The lowest regulated price for gas is presently 28¢/MMbtu. The highest regulated price is $5.48/MMBtu for tight gas. Because those low regulated prices existed, unregulated prices last year reached a high of nearly $10/MMBtu. In between those extremes many other prices prevailed. This enormous variation causes confusion resulting in injury to all segments of the gas industry and to the consuming public.

Producers were badly confused because the economics of prudent action were totally distorted by regulation. For example, the cheapest way to add to natural gas production today is by in-fill drilling in old gas fields; yet capital expended for this purpose would earn an unacceptably low return because the price of old gas is fixed at artificially low levels in perpetuity. At the other extreme we saw a boom in deep drilling caused by a common belief that all gas produced from below 15,000 feet would sell at "the 107 price," which was thought to be $10/MMBtu; today--as prices of deep gas fall rapidly--we have a "bust" in deep drilling with rigs stacked all over the landscape. The injury to producers--and to the drilling service industry which supports them--is very real.

Further, we have sent confusing--and costly--signals to foreign countries from whom we purchase gas. Although Congress, our regulators and the purchasing pipelines have tried to talk down the price of gas imported from Mexico and Canada, today pipelines are paying $4.94/MMbtu for gas from those two countries and then transporting those supplies hundreds of extra miles to our principal markets. Obviously, those prices are above market clearing levels. But how can we argue with the Canadians and the

Mexicans when our own deep gas producers have recently been receiving nearly $10/MMBtu?

Ironically, one of the principal reasons for preserving the labyrinth of controls on old gas in 1978 was to prevent a "windfall" to producers. It is now apparent that Congress did not prevent that "windfall" from occurring. It simply transferred the "windfall" from the old gas producer to the deep gas and the tight sands producer, to Mexico and to Canada, and to all the other sources of high cost, non-conventional gas.

The pipelines have also suffered serious injury from NGPA pricing. The interstate pipelines were supposed to benefit from the "old gas cushion." Under the NGPA, they were allowed to continue to pay the regulated price for all gas discovered before April 1977--a price which was far below the market value of the gas--and to roll in those low prices with the higher cost of new supplies. Unfortunatley, a good deal of the cushion was "spent" on deep gas, on Canadian and Mexican gas, and on other non-conventional sources with the result that even the rolled-in prices of interstate pipelines went up much faster than had been anticipated. The "oil glut" of the last three years has produced falling product prices with the result that in many cases delivered pipeline costs clearly exceed market clearing prices.

Intrastate pipelines have been badly hurt by the old gas cushion. Under the regulatory scheme which prevailed prior to 1978, sales of gas to intrastate pipelines were not subject to regulation but were determined by arms' length bargaining between pipeline and producer. The typical intrastate pipeline purchase contract provided that the field price of gas would be adjusted annually or semi-annually to the average of the three highest prices paid in a particular district. As a consequence, gas purchased under a ten year old contract sold at essentially the same price as gas sold under a new contract. Thus, intrastate pipelines generally had no old gas cushion.

After 1978, however, the intrastate pipelines were forced to pay prices competitive with those paid by the interstate pipelines for new supplies. Without an old gas cushion to soften the impact of new, high-cost gas supplies, the delivered costs of intrastate pipelines rose rapidly. A year ago, two of our largest intrastate pipeline suppliers forecast that the delivered price of gas to us by January 1 of this year would be approximately $5.00/Mcf. Those prices clearly exceeded the market clearing level. Fortunately, prices did not escalate as rapidly as had been forecast and are instead an average of $4.45/Mcf. The reason these forecasts failed to materialize was the emergence of market forces which compelled a decline in price.

Gas distributors, such as Entex, have also suffered from the confusion created by NGPA pricing. Obviously, distributors are not a party to the purchase contracts which pipelines and producers negotiate between themselves. Yet we stand or fall in the marketplace as a consequence of the prices which flow through to us from our pipeline suppliers. We can--and frequently do--convey our opinions about gas pricing to our pipeline suppliers, and our opinion is that most of our suppliers have been paying too much for gas. Our message is not nearly as effective as the message now being sent by the market--lost loads followed by reduced field takes.

From 1978 to 1982, the NGPA obscured the message which the marketplace was trying to send to the producers and the pipelines through the gas distributor. A deadly combination of numerous vintages of gas, maximum prices which became minimums, reclassifications of gas from one category to another, rolled-in pricing and other regulatory anomalies made it difficult for pipelines to immediately perceive the economic consequences of their purchases. Market messages simply did not transmit clearly through the mirk of a half-free, half-controlled environment.

Finally, the consumer was also hurt by the confusion which NGPA pricing has created. Until recently, many large customers with whom we deal frequently expressed their concern that gas in the field might go to $10/MMbtu upon decontrol; as a consequence, they deferred long term decisions about energy utilization. Small customers are for the most part unaware of the reasons their bills have gone up, but they are painfully aware that they are paying a great deal more for gas than they used to. Beyond doubt, gas customers are paying more for gas in Houston than they would have had a free market prevailed since 1978 when the NGPA subjected the intrastate pipelines from whom we purchase our Houston supply to field price controls. This again is a direct result of preserving controls on old gas.

In short, all of us--producers, pipelines, distributors and consumers--have been hurt by the confusion which NGPA pricing has created. It is for this reason that we advocate the decontrol of old gas and the resultant elimination of the old gas cushion.

2. THE CHAOS PRODUCED BY A COMBINATION OF NGPA-INDUCED CONFUSION, A RECESSION AND AN OIL GLUT HAS BEGUN TO CREATE A MARKET ENVIRONMENT; NOW IS THE TIME TO DECONTROL NATURAL GAS FIELD PRICES.

Very few people outside the natural gas industry understand that the industry is currently in a highly chaotic state. The principal reason for that chaos is the confusion produced by four years of a half-controlled, half-free environment under the NGPA. Certainly, that confusion was vastly heightened by a very deep recession and by rapidly falling crude oil and product prices. Years from now, I believe the 1982-84 period will be seen as pivotal in the history of our industry. Economic historians will mark this period as the time when field prices began to be established on a rational, free market basis. But for those of us who have some responsibility for this industry--whether we be distributors, pipelines, regulators or legislators--the current period is sheer hell.

Out of all the sound and fury, however, it is important to notice what is beginning to happen. Despite the old gas cushion, a free market at the wellhead is actually beginning to develop. Interstate pipelines who bought deep gas because of the old gas cushion are exercising "market out" clauses and dramatically reducing the prices they are willing to pay; to be sure the price paid still seems to be higher than the market clearing price (a phenomenon which can only be attributable to the remaining influence of the old gas cushion), but it is far lower than it was only a year ago. Both interstate and intrastate pipelines are reducing the price they are willing to pay for tight gas, generally to market clearing levels. Purchasers who can offer producers high takes can now buy new gas below the 102 price, a result which would have been unthinkable only a year ago.

What is the explanation for this recent rationality at the wellhead? The answer is simple. The free market began to work. Wellhead prices got so high that very sizeable markets were lost. In our part of the country, electric utilities converted to other fuels, principally lignite, as rapidly as possible. Ammonia manufacture has nearly come to a halt on the Gulf Coast because of high gas prices, importation of foreign ammonia and poor agricultural markets. Primary aluminum manufacture and basic petrochemical production have been shifted to overseas locations where gas is either a waste product or has a far lower price than in this country. These effects have been magnified by the recession and by the conservation undertaken by end users in response to high gas prices. We are aware of a large chemical facility located in Texas which has reduced its consumption of gas from 650,000 Mcf/d to 350,000 Mcf/d without fundamentally changing its output. These load losses reflect permanent, structural changes which are the direct result of high field prices.

Not so permanent, but equally as damaging for the present, has been the loss of substantial loads to oil. The change in Federal policy which occurred early in the Reagan administration deregulating refining and distribution of petroleum products began the creation of a free market in that commodity. The inability of OPEC to maintain control of crude prices dramatically accelerated this process. For all practical purposes, oil products now trade in a totally free market, moving up and down rapidly in response to supply and demand considerations. The free market in oil is spreading into gas markets whether we like it or not.

The effect of these load losses has dramatically reduced takes of gas in the field. Producers have been gradually shut in because there were insufficient markets for gas at the levels to which wellhead prices had risen. Producers, many of whom were faced with high interest charges and loan maturities, began to be willing to sell gas at lower prices. Purchasers who could actually take gas at reasonable levels were able to drive particularly good bargains.

Pipelines have had ample incentive to bargain effectively with producers. Their throughput has fallen substantially, and they have been pressed hard by their distributors, by their direct market customers, and by their regulators. While many pipelines still have delivered prices which are in excess of market clearing levels, important progress has been made. For the first time in memory, Entex has received a reduction in gas prices from both of the intrastate pipelines from whom it purchases gas in Houston. We expect this welcome trend to continue for at least the next several months.

Entex strongly believes that the time to decontrol all gas is now. Nearly all knowledgeable people who are familiar with the problems of the gas industry will admit--at least in private conversation--that gas at the wellhead should eventually sell in a free market. The transition, they say, is the problem. We strongly believe that the best time to make this transition is at a time when supply is long and demand is short. We believe that the repeal of controls on old gas will almost immediately eliminate the purchase of gas in the field at prices higher than market clearing levels. We further believe that the market clearing price will fall to levels which will rebuild demand.

All of us need to remember that the function of price in a free market is to produce a balance between supply and demand. The "correct" price is the price at which supply and demand are in balance. If there is an excess of supply (as we have presently), it is because the price is too high. Conversely, if there is a shortage (as we had a few years ago), it is because the price is too low. Since we now have an excess of supply, we can safely predict that field prices would decline if Congress were to decontrol field prices now. The development of resources which are now underpriced would further add to the supply, again tending to reduce price.

The current gas glut will not go on forever. Although many of us debate whether the current imbalance merely reflects excess deliverability or longer term structural changes in the marketplace, everyone would agree that if present drilling rates continue for several years, a gas shortage will once again occur. A gas shortage would reverse all the progress which has been made in creating a free market and would increase the dreary and unworkable prospect of recontrol and still deeper shortage. Producers will go back to drilling when the present confusion abates and the economics of gas exploration can once again be perceived. Decontrol will provide the clarity necessary to that understanding.

Now is the time for decontrol; another like it may never come. If we succeed, gas will once again sell on a one-price basis, whether it is old or new, shallow or deep, tight or loose. Natural gas reserves will be developed in an orderly fashion from least costly to most expensive. The industry will once again operate on an economically rational basis.

3. ALTHOUGH WE PREFER COMPLETE DECONTROL, ENTEX BELIEVES THAT A COMPROMISE BETWEEN THE PARTISANS OF COMPLETE DECONTROL AND OF THE STATUS QUO (OR PERHAPS EVEN OF RECONTROL) IS HIGHLY DESIRABLE.

Although Entex would strongly prefer to see gas field prices decontrolled now, it is apparent to us that the chances of persuading Congress to adopt legislation producing this result are low. Since realism is almost always a virtue, we have been quietly urging a compromise between all segments of the industry. It is not our mission to specify that compromise. Nevertheless, we think the general outline of a compromise which would provide something for everyone is apparent.

On the one hand, pipelines, distributors and consumers need relief from some of the contracts which were entered into on the assumption that old gas would be controlled forever. I refer to indefinite price escalators and to high take-or-pay provisions. Perhaps contracts to purchase high cost gas from foreign sources should fall in the same category. These contractual hangovers of the old gas cushion obstruct the ability of a free market to function effectively.

At the present time, we see evidence that some pipelines are willing to breach contracts on grounds that until recently would have been thought "novel." Perhaps the 1985 "fly-up" and resulting chaos which has been widely feared by pipelines, distributors and end users will be blunted by similar action, and perhaps these "novel" defenses will be sustained. I think, however, that it would be highly prudent to address the problems created by indefinite price escalators and high take-or-pays in a legislative, rather than a judicial, forum. The problem was created legislatively, and it should be solved legislatively.

There are a variety of techniques which could be used to control indefinite price escalators. Some advocate outright prohibition on the theory that such provisions were entered into in an environment which assumed permanent control of old gas and that just as Congress has changed one side of the bargain by decontrolling (even gradually) old gas, so should Congress change the other side of the bargain. At the other extreme are various "caps," allegedly reflecting a market clearing price or a percentage of a market clearing price or a proxy for a market clearing price. Entex would support any solution which can be demonstrated to be both workable and legally sustainable and which would permit the market to work. We do strongly oppose any "cap" which is cross-indexed to the price of a competing product, such as the price of refined products.

Take-or-pay provisions are a problem for some pipelines. As many of you are aware, this problem has been handled in Texas by a Railroad Commission order directing pro rata takes notwithstanding take-or-pay provisions. While this solution is far from perfect, it is workable. I would recommend that Congress consider such a solution despite the obvious administrative problems which pipeline proration would create. I would recommend exceptions from pro rata takes for obvious problems, such as drainage and well damage, and also for renegotiated 107 contracts.

On the other hand the producer needs relief from the low prices which the NGPA imposed on old gas. Those controls force the producer to sell his gas at less than market clearing levels, and they are unique in our present economy. Moreover, they discourage further development of low cost reserves because the return from in-fill drilling is frequently inadequate at controlled prices. It is our suggestion that part of any compromise should be the decontrol of old gas over as short a period as is politically possible, say two to three years.

Perhaps other elements need to be included in any compromise; perhaps the elements suggested above need to be tilted one way or another to produce a proposal which will pass. But we strongly urge that the effort be undertaken and commend this Committee for its willingness to consider this critical subject. We are all aware that it is a political "hot potato" which will require adroit handling in order to achieve a most necessary result.

4. WE BELIEVE THAT S. 615 IN ITS PRESENT FORM IS NOT AN ACCEPTABLE COMPROMISE.

Although Entex strongly supports the concept of a compromise which would hasten the day of complete decontrol, Entex opposes S. 615 in its present form. It is our perception that S. 615 is an attempt to find a device which will assure consumers that decontrol will not increase their utility bills. Whereas others--including our own Company--have sought to do this by persuasion (citing the well-known benefits to consumers of a free market), S. 615 seeks to assure the consumer that his bill will not go up by imposing a new system of regulation. In our opinion, this country needs to proceed to decontrol by taking off--not adding to--the existing controls. While S. 615 is a useful vehicle for dialogue, we view it as a step away from a free market.

We have not as yet had an opportunity to completely study S. 615 and to make anything like a definitive statement on its advantages and disadvantages. I would, therefore, like to confine my comments to those matters which presently appear to be basic: (1) the new system of controls on pipeline PGA's; (2) the "gas cap"; (3) the take-or-pay provisions; (4) the elimination of distinctions between interstate and intrastate pipelines; and (5) the contract carriage provisions.

a. Pipeline PGA's.

Section 101 seeks to amend the existing provisions of Section 603 of the NGPA by in effect prohibiting an increase in any pipeline's PGA by an amount greater than the "standard adjustment," which is basically an estimate of the rate of inflation calculated on a nationwide gas cost base. Without a general rate proceeding on the prudence of its purchasing practices, a pipeline cannot pay more than its current average gas cost plus the standard adjustment. The fundamental message conveyed by the provision is clear: field prices will be decontrolled but only to the extent that the pipelines are permitted to pay for it.

Section 603(a) as revised would prohibit the immediate pass through of purchased gas costs to the extent such costs increase faster than the rate of inflation. Greater increases could not go into effect unless the FERC had made an affirmative determination after hearing that the costs were just, reasonable and prudently incurred. Given the enormous potential penalty of being unable to pass through gas cost plus the short term loss of working capital even if the increase in gas cost is eventually upheld, prudent pipelines simply will not pay more for gas than an amount which in the aggregate would exceed the rate of inflation. Is this really decontrol? We think not. We think it is gravely misleading to say that the producer can receive more than the old gas price, but that the pipeline cannot pay it.

In actual operation, the proposed Section 603 could prove to be highly discriminatory. Although the standard adjustment is a nationwide amount applicable to all pipelines, the base for each pipeline is its own average gas cost. There is presently an enormous variation between the gas costs of the various pipelines in this country. Since a low cost pipeline would have very little base to work from in renegotiating new contracts on old gas, such a pipeline would be harmed immensely by the new system of PGA controls. Under almost any system for decontrol the low cost pipelines will have to adjust to loss of their old gas prices; under S. 615, however, they would lose not only their low prices but the reserves themselves. The market clearing prices necessary to renegotiate contracts successfully would produce dollar increases in excess of the standard adjustment and would require a general rate proceeding.

High cost pipelines could benefit from the revised Section 603 if they can find a way to dump a major increment of high cost supply out of their calculations. If, for example, a pipeline with a high gas cost can find a way to avoid taking expensive LNG, it would have a great deal of room to acquire lower cost reserves lost by low cost pipelines. Notice, however, that this potential advantage would be lost or reduced if a high cost pipeline took any action to reduce gas cost prior to the effective date of S. 615. S. 615 thus discourages the current, laudable efforts of high cost pipelines to force their gas cost down.

While the abuses suggested above might or might not occur, the point is that in creating a whole new set of controls revolving around pipeline PGA's, Congress would be creating a new regulatory scheme as pernicious as the old gas cushion which S. 615 purports to eliminate. Entex believes that the way to eliminate controls is to eliminate them, not to replace them with a new regulatory scheme.

b. The "Gas Cap."

Section 301 would add a new Section 111 to the NGPA which would establish a new limit, or price cap, for all currently controlled natural gas except Section 107 gas. The price cap would be the lesser of the maximum lawful price under any other section of the NGPA and the "gas cap price," which would be the average price of natural gas under recent new or amended contracts. In submitting the new Section 111, the drafters took aim at the tendency of maximum prices to become minimum prices. They did so, however, by imposing a new maximum price--the "consensus All-America price"--which will become the new minimum. In our opinion, this is another step in the wrong direction.

It is quite true that until recently the maximum prices established by Sections 102, 103 and 107 have tended to become price floors propping up wellhead prices instead of holding them down. As is explained earlier, the current imbalance between supply and demand has finally cut the knot that bound maximum prices to minimum prices. This highly desirable result is a result of the free market at work. The new Section 111 reties the knot by attempting to legislate what the free market creates. To state the proposition is to reveal the internal inconsistencies therein.

The "gas cap" is not only inconsistent with a free market, but it invites the same type of game-playing which was produced by the old gas cushion and which is the inevitable consequence of price regulation. At the present time pipelines are beginning to buy gas in isolated transactions at less than the 102 price. The existence of such prices would tend to lower the gas cap and might produce prices on controlled gas at levels less than the 102 price. The existence of a gas cap would stiffen the negotiating position of pipelines because concessions on new contracts could produce lower prices on existing 102 contracts. Entex recommends that we let the free market work and not create new mechanisms which the inventive will surely use to further a purpose which will frustrate the intended result.

c. Take-or-Pay.

As indicated in Part 3 of my testimony, we believe that the take-or-pay problem is best addressed through a temporary system of pro rata takes on a pipeline-by-pipeline basis. Texas has such a system at the present time. While the system has flaws and is not easy to administer, it does work and provides a rough measure of justice among producers. New Section 315 is a worse approach in our opinion.

First, the 70% of available deliverability--above which takes are excused--is too high. Takes by most intrastate pipelines in Texas, for example, are well below this figure. The only alternative available to a pipeline operating well below this limit would appear to be to release the reserve entirely. Second, the mechanics of release of quantities above 70% are unclear: if one releases 30%, does the 70% then apply to the reduced obligation, thus starting the process all over again? Third, the 70% provision appears not to take into account seasonal variations in takes necessitated by seasonal variations in loads. One needs to remember that it is the market which creates the takes, not the reverse.

Perhaps the incongruities of the proposed Section 315 can be eliminated by further study and revision. In its present form, it is a provision which we would not support.

d. Intrastate Purchase of Interstate Gas.

Section 401 would facilitate transactions between the interstate and intrastate markets without subjecting those transactions to certification procedures under Section 7 of the Natural Gas Act and without requiring intrastate companies to become jurisdictional "natural gas companies" under that Act. Entex strongly opposes this provision because we believe it fundamentally alters the manner in which the industry has been organized and regulated since its inception.

The Natural Gas Act of 1938 was designed to close a regulatory gap which had theretofore existed. The commerce clause prevented states, who already had jurisdiction over intrastate pipelines and distribution utilities, from regulating the interstate movement of gas. That gap was closed by giving the old Federal Power Commission jurisdiction over interstate pipelines. Extensive litigation (and the Heinshaw Amendment) has created a well defined set of relationships between state and federal authorities and between interstate pipelines, intrastate pipelines and local distribution companies.

The systems of regulation applicable to interstate pipelines and to intrastate pipelines are fundamentally disparate. Oversimplifying, interstate pipelines are subject to pervasive regulations including overall cost of service and rate of return limits. Many intrastate pipelines, including those in Texas, Louisiana and Mississippi, operate in an essentially free market environment in which rates to large volume customers are set on a market basis and in which there are no limits on rate of return. Many other illustrations of the differences between federal and state regulatory schemes could be given.

S. 615 reshuffles these well defined relationships. It would permit an intrastate pipeline to purchase from an interstate pipeline without subjecting itself to the Natural Gas Act. Essentially, an intrastate pipeline would have all of the privileges of being an interstate pipeline without any of the obligations which go with that status. In such an environment it is inevitable that new regulatory gaps will arise and that enormous confusion will follow. Entex purchases from both interstate and intrastate pipelines. We want to know who is who.

e. Contract Carriage.

Entex has grave reservations about the proposed Section 317 which would provide that the FERC shall order an interstate pipeline to transport gas on behalf of the producer and purchaser under terms and conditions prescribed by the Commission. Transportation arrangements are, of course, common under existing law and the FERC has full authority to regulate such transactions. The obvious intent of Section 317 is to provide regulatory incentives for large industrial users to enter into purchase arrangements with producers and to compel the pipelines to transport the gas so purchased.

On its surface the proposal appears to be a means of promoting competition by eliminating the wholesaler and the retailer. When the distributor loses an industrial sale, the lost margin must be found elsewhere in order to maintain the financial integrity of the utility. The result is an increase in the rates to domestic customers. Entex submits that the decontrol issue is difficult enough without setting of rate cases all over the country because of lost industrial sales.

The proposed Section 317 would have the additional vice of permitting the segregation of gas cost without regulatory scrutiny. By way of explanation, pipeline gas costs are an average of high and low prices; distributors with multiple sources of supply also sell gas on a basis representing the average of their sources of supply. In a falling market such as that which presently prevails, a large industrial user could purchase gas at the lowest price at which a pipeline could purchase gas and thereby avoid buying at the average cost. While segregation of supply by distributors has numerous regulatory precedents as a necessary competitive technique, it is only available subject to regulatory scrutiny. No such scrutiny would be attendant upon a transaction between a large industrial customer and a producer.

CONCLUSION

Entex renews its support for complete decontrol which it believes to be free from the defects in S. 615 noted above. We are willing to support a reasonable compromise leading to decontrol on a step-by-step basis. We do not feel that S. 615 fits that description. The fundamental defect of S. 615 is that it proposes that we get to the Promised Land of Decontrol by detouring through a wilderness of new controls. It may well be that this industry cannot proceed immediately to decontrol. But it should proceed on a straight road to that objective with decreased control at each milestone along the way. We urge that S. 615 be rejected or substantially modified.

The CHAIRMAN. Mr. Davis.

STATEMENT OF O. C. DAVIS, CHAIRMAN OF THE BOARD AND PRESIDENT, MIDCON CORP.

Mr. DAVIS. Mr. Chairman and members of the committee.

My name is O. C. Davis. I am chairman of the board and president of MidCon Corp.

I appreciate your invitation to appear here today to comment on the provisions of Senate bill 615.

We at MidCon are concerned about the impact of natural gas prices on consumers, and we want to work with Congress to insure that consumers are provided with a secure, dependable supply of gas at the lowest possible price.

We have reviewed and analyzed S. 615, and one thing above all is clear. It will not provide protection from price increases.

Those who argue that it will are misleading consumers of this country.

We strongly oppose those provisions of S. 615 that would, one, deregulate old gas; two, permit the terminations of contracts on January 1, 1985, along with the provisions concerning take-or-pay, and the passthrough, purchased gas costs. These proposals, if it is enacted, would unquestionably cause chaos in the natural gas market, and would result in higher prices to the consumer.

I should tell you something about MidCon. It is an energy corporation with subsidiary companies in oil and gas exploration, contract oil and gas drilling, natural gas transmission, and coal.

MidCon's major subsidiary is Natural Gas Pipeline Co. of America, which I will refer to as "Natural," one of the largest interstate gas transmission companies in the Nation, which has historically sold and transported approximately 5 percent of the gas consumed in our country.

Natural currently supplies two-thirds of the gas consumed in the State of Illinois, which is the fifth largest gas-consuming State.

Natural supplies one-quarter of the gas consumed in Indiana, and one-third of the gas consumed in Iowa. Significantly, its purchased gas costs is one of the lowest in the United States.

The price for gas delivered by Natural in the Chicago area is considerably lower than prices charged by other pipelines serving utilities in other major metropolitan areas.

The major factor in keeping costs low is Natural's substantial supply of old gas. A great deal of this gas was obtained as a result of vigorous supply acquisition efforts by Natural in the 1970's.

Substantial financing commitments were made under the FPC's advance payment program, wherein Natural and their producers agreed to the prevailing FPC's prices and then they entered into a requisite and practical commitments and undertook the installation of facilities necessary to attach the supply.

These prudent supply efforts that were paid for, in part by our customers, would not be penalized by the adoption of new legislation that would either eliminate this gas from markets or significantly increase its cost.

Moreover, deregulation of oil gas would confer no benefits on consumers and would instead lead to higher prices, decontrol of prices of old gas, most of which is owned by the major producers, would not provide broad incentives for exploration for new gas supplies needed for present and future gas consumers.

Further, it would not aid significantly in the renegotiation of high-priced contracts because no pipeline has a major portion of its supply with the same producers covering equal volumes of low- and high-cost gas.

The market-out provisions of title III of S. 615, in our opinion, is the most onerous section of the bill. If enacted, it would enable low-cost gas to seek either higher prices from the pipeline, or market it to others.

This would place Natural—which has significant supplies of old gas, presently about 70 percent of its total supplies—in an intolerable position.

Indeed, Natural would be faced with a "Hobson's Choice."

If it is forced to pay higher prices, for example, likely in the range of $4 per thousand cubic feet for such gas, this would drive prices paid by consumers even higher.

Conversely, if Natural decided not to pay the higher prices, it would stand to lose over 50 percent of its supply in 1985, and endanger service to consumers.

Moreover, the average cost of Natural's remaining gas, which would be mostly new gas, would still be in about the $4 price range.

If I may summarize, decontrol and/or loss of old gas, low-cost gas, will definitely lead to higher burner tip prices for our consumers.

I have my written statement that covers most of the rest.

Thank you, and I am prepared for questions.

The CHAIRMAN. Thank you very much, Mr. Davis.

[The prepared statement of Mr. Davis follows:]

Statement of O. C. Davis
Chairman of the Board and President of
MidCon Corp.

Mr. Chairman and Members of the Committee.

My name is O. C. Davis and I am Chairman of the Board and President of MidCon Corp. (MidCon). I appreciate your invitation to appear here today to comment on the provisions of Senate Bill 615 and other pending legislation on natural gas issues. I am pleased that this Committee recognizes the important role natural gas pricing plays in today's world. We, at MidCon, are also concerned about the impact of natural gas pricing on the consumer, and we want to work with Congress to ensure that consumers are provided with a secure, dependable supply of gas at the lowest possible price.

We have reviewed and analyzed S. 615, introduced by the Chairman, Senator McClure, at the request of the Administration. We are pleased to note Title V which would repeal certain sections of the Powerplant and Industrial Fuel Use Act, and the incremental pricing requirements of Title II of the Natural Gas Policy Act of 1978 (NGPA). We support this action, as we have done in the past.

We strongly oppose certain provisions of S. 615; in particular, the provisions which would deregulate gas priced under Sections 104 and 106 of the NGPA; the market out provisions in Title III; and the restrictions on the purchased gas cost passthrough in Title I of the Bill. These provisions would cause chaos in the natural gas markets and would result in higher prices to the consumer. These provisions would hurt the consumers and would not give them protection from price increases as the Bill is intended to do.

As a member of the American Gas Association and the Interstate Natural Gas Association of America, we support the statements by these groups with respect to S.615.

INTRODUCTION

MidCon is an energy corporation with subsidiary companies in oil and gas exploration, contract oil and gas drilling, natural gas transmission, and coal. MidCon's major subsidiary is Natural Gas Pipeline Company of America (Natural), one of the largest interstate gas transmission companies in the nation. Natural has historically sold approximately 5% of the gas consumed in the U.S.

Natural's pipeline network consists of over 12,500 miles of pipeline comprising two major transmission systems. One extends from the West Texas and New Mexico natural gas production areas; the other from the Gulf Coast areas of Texas and Louisiana. Both systems terminate in the Chicago Metropolitan Area. The company is a partner in three major offshore gas transmission systems in the Gulf of Mexico which connect offshore production to Natural's pipeline system. These offshore pipelines are the U-T Offshore System (UTOS); the High Island Offshore System (HIOS); and the Stingray Pipeline. The company is also a partner in a new pipeline system which was completed last fall, the Trailblazer

Pipeline. Trailblazer links the markets of the Midwest and East with gas reserves in the Rockies.

Natural also owns and operates an extensive system of underground storage facilities to provide storage services to its customers and to balance supply availability with market demand. Four storage facilities are located in Illinois, three in Iowa, and one each in Texas and Oklahoma.

NATURAL'S MARKETS

Natural currently supplies 2/3 of the gas consumed in the State of Illinois, the fifth largest gas consuming state. Natural supplies 1/4 of the gas consumed in Indiana and 1/3 of the gas consumed in Iowa. Forty-nine gas utility companies and municipalities located along the pipeline routes purchase gas from the company. These customers are located in the States of Nebraska, Missouri, Kansas, Wisconsin, Texas and Oklahoma as well as Illinois, Iowa and Indiana.

For fiscal 1981 (ending September 30, 1981), Natural's average purchased gas cost was $1.93 per Mcf. For fiscal 1982, the cost was $2.24 per Mcf and as of March 1, 1983, the cost is $2.58 per Mcf. This purchased gas cost is one of the lowest in the United States. The price for gas delivered by Natural in the Chicago area is considerably lower than the prices charged by other pipelines serving utilities in other major metropolitan areas. Based on rates currently in effect, the city gate price per Mcf for Chicago is $3.54. This can be compared to $4.95 per Mcf in Kansas City and $4.55 per Mcf in New York.

Natural's average purchased gas costs continue to increase. Several factors have caused the average price of purchased natural gas to increase in recent years. The two main factors have been the regular increase in ceiling prices allowed under the NGPA and the cost of replacing depleted supplies of old gas.

A major factor in keeping costs low is Natural's supply of "old" gas; that is, gas priced primarily under Sections 104 and 106 of the Natural Gas Policy Act. Large quantities of this gas have been obtained as a result of vigorous supply acquisition efforts by Natural in the early 1970's. Natural and the producers agreed to the FPC approved price prevailing at the time, entered into the requisite contractual commitments and undertook the installation of facilities to attach these supplies. Substantial financial commitments were made under the FPC's advance payment program. Moreover, we have minimized contracting for high priced deregulated domestic gas; and such gas represents less than 1/2 of 1% of Natural's total supply. The fruit of all these efforts is Natural's large supply of relatively low cost gas. These prudent supply acquisition efforts should not be penalized by the adoption of new legislation which would either eliminate this gas from our system or significantly increase its cost.

Natural has implemented policies to keep its purchased gas costs low. We are utilizing the "market out" clauses in gas purchase contracts where we have this right, to refuse to purchase gas priced above a total cost including taxes of $3.35 per Mcf. Also, we are not currently taking any gas from our largest Canadian supplier, and have cut back our remaining Canadian supplier. Our purchasing policies do not differentiate between type or depth of gas. We seek to obtain a price at which we can market the gas. These policies, along with our long range planning, have kept gas costs to our Midwest consumers to a minimum.

IMPACT OF S.615

We have reviewed S. 615 and have serious problems with several of its provisions. Our major concerns are with Title I and Title III. We also have some concerns over other parts of the Bill and will cover these briefly later on.

OLD GAS AND MARKET OUT PROVISIONS

We vigorously oppose any deregulation of old gas; that is, gas priced under Sections 104 and 106 of the NGPA. Deregulation of old gas would confer no benefits on consumers and would instead lead to higher prices. Decontrol of the price of old gas, most of which is owned by the major producers, would not provide an incentive for exploration for new gas supplies needed for present and future gas customers. Moreover, it would not aid significantly in the renegotiation of high priced contracts, because no pipeline has contracts in total or with the same producer covering equal volumes of low and high cost gas.

The "Market Out Provision" proposed in Title III of S. 615 is, in our opinion, the most onerous provision of the Bill. This provision would enable producers who hold the majority of low cost gas to seek either higher prices from the pipelines or take this gas and market it to others. This places Natural, who has significant supplies of low cost gas (presently over 70% of our supply is this type of gas) in an intolerable position. Natural would thus be faced with a "Hobson's choice". If it is forced to pay higher prices, i.e., some $4.00 per Mcf for such gas, this would drive prices paid by consumers even higher. Conversely, if Natural decides not to pay these higher prices, it would stand to lose over 50% of its supply in 1985, thereby endangering service to consumers. Moreover, the average cost of Natural's remaining gas would still be $4.00 per Mcf.

Our studies indicate that a significant increase in the cost of gas to consumers now supplied by Natural would result from the deregulation of old gas. The DOE analysis of S. 615 published on February 28, 1983, projects domestic wellhead prices using two assumptions on future oil prices. If we assume that this analysis is correct, Natural's annual cost of domestic gas in the first year alone would be increased by

$500-700 million using DOE's base case and $250-350 million using DOE's low oil price scenario. Our own studies indicate that the impact of the proposed "Market Out Provision" will increase Natural's annual cost of domestic gas by $500 million to $1 billion, a 25 to 50% increase.

The impact of such increases on the consumers served by Natural's customers after 1985 are predictable. Major loss of industrial load due to fuel switching or plant closings can be expected. The remaining residential and commercial customers will then see further increases as fixed transmission and distribution costs are recovered through much lower volumes. Midwest consumers would be severely impacted by this sudden rise in prices. It is important to remember that Midwest consumers paid higher rates as the result of the advance payments programs in the early seventies under which Natural was able to acquire large supplies of old gas.

These provisions seem to be based on faulty assumptions that pipelines purchase equal amounts of high cost and low cost gas in total or from the same seller, and can therefore negotiate to pay less for the high cost gas by agreeing to pay more for low cost gas. These assumptions are not true. As demonstrated by studies conducted by the EIA, pipelines with large amounts of old gas are not buying large volumes of high cost gas, nor are they paying high prices. Because of their better gas supply position, they can forego high cost supplies. In Natural's case, less than 1/2 of 1% of its supply is high cost Section 107 gas. Natural is not entering into any new contracts for high priced deregulated gas supplies.

Natural's purchase decisions are not based on looking at any specific volume of price-controlled gas and concluding that it can purchase some other volume of high-cost gas as a result. Natural, in cooperation with its customers, looks at their markets and then contracts for gas at a price not exceeding an estimated market clearing level. The concept of a price-controlled gas cushion that can absorb high priced gas that would not otherwise be purchased is a myth.

In addition to the detrimental effect these provisions would have on low priced gas, the administration of these provisions would be a nightmare.

In summary, decontrol or loss of Sections 104 and 106 low cost gas will lead to higher burner tip prices for the consumer. Markets will decline, and more and more industrial load will be lost. This will place even more burdens on residential consumers who must absorb more of the fixed transmission and distribution costs previously paid by the industrial customers. Pipelines, faced with declining markets, will curtail their gas acquisition efforts, causing producers to curtail exploration programs. Shortages will occur. Certain industrial customers will be forced to shut down resulting in increased unemployment and economic stagnation.

CONTRACT ABROGATION

The market out provision of Title III would cause catastrophic changes in natural gas markets. Natural has in excess of 2,800 gas purchase contracts and 267 transportation or exchange contracts which would be affected by these provisions. FERC estimates that there are over 30,000 gas purchase contracts which could be terminated under the market out provisions of S. 615. The natural gas market would be thrown into total confusion.

Compounding the detrimental effects of this provision is the fact that the Bill provides for the market-out to begin on January 1, 1985, the height of the winter heating season. This increases the negotiating leverage of the producers because security of supply is vital in the winter months.

S. 615 also imposes a transportation obligation on the pipeline that was a party to a terminated contract. The pipeline is required to transport the gas regardless of who terminated the contract. We feel that a pipeline should transport for others on a best efforts basis and only if the pipeline determines that available capacity exists to accomplish such transportation.

PGA PASSTHROUGH

My second major concern with S. 615 regards the limitations on purchased gas cost passthrough found in Title I . This penalizes low cost, prudent pipelines.

Pipelines with large supplies of old gas will have lower average costs for purchased gas. The addition of an inflation adjustment based on the national gas purchase cost will not enable the low cost pipeline to bid as much for new supplies as a pipeline with higher average gas costs. Pipelines with a preponderance of new gas will have a higher average purchase gas cost, and thus will be able to bid more successfully for new supplies. Furthermore this provision applies only to interstate pipelines thereby giving intrastate pipelines and end users a significant advantage in bidding for new gas. The NGPA was passed to deal with a tremendous two tier market problem. S. 615 would create an even greater monster. We oppose any limitations on PGA passthroughs which would penalize pipelines which were diligent in acquiring supplies of old gas.

TAKE-OR-PAY

We are pleased that S. 615 recognizes the problem of excessive take-or-pay required under certain contracts. Title III would allow pipelines to lower their take requirements under gas purchase contracts to 70% of deliverability. The Bill's provision would put the pipelines at risk of losing 30% of their deliverability and reserves. If that happened, a pipeline could not vary its purchases between winter and summer and could not make up gas not taken. In short it would have 100% take or pay on 70% of its prior gas reserves and no opportunity to make up gas not taken but paid for. In the operation of a pipeline it is essential that there be a make up right. We feel that this 70% level is too high. We propose reducing the take-or-pay level to 50% of deliverability for a period of three years and to allow make-up of the other 50% in accordance with the existing terms of the gas purchase contracts. This would enable a pipeline to recover gas not taken, and would guarantee that pipelines would not lose valuable gas reserves needed for present and future customers.

GAS CAP

We are in favor of a cap on gas prices to blunt the effect of escalator clauses. However, we see technical problems with the cap proposed in Title III of S. 615 because it is based on estimates that must be filed within five (5) days of the execution date of a contract. It is unrealistic to base a cap on estimates which must be made in some cases long before the gas even begins to flow. We propose a cap based on the weighted average price of all gas purchased in the most recent three (3) month period for which data is available under new contracts entered into after the date of enactment.

EQUAL ACCESS PROVISIONS

Title IV would provide wide access to interstate markets, transportation and supplies with little FERC oversight of end users, intrastate pipelines and producers. This, too, would lead to the reimposition of a two tier market. We believe this would unfairly burden and disadvantage interstate pipelines and their distribution customers. In particular, it would permit unlimited interstate movement and sales of natural gas without the need to satisfy the requirements of the Natural Gas Act (NGA). This is in direct contrast to the conditions under which the interstate pipelines and their distribution customers have operated for many years. Such traditional participants in the interstate market would be joined by others who would not be required to operate under the same terms and conditions. This would be unduly discriminatory and should not be allowed.

We do not object to greater access to supply as a benefit for intrastate pipelines. Out of state sources to help meet demand should be encouraged. Such gas should be transported to intrastates by entities which would be subject to FERC certificate and rate jurisdiction. We would support changes in the NGA to ensure that the _receiving_ intrastate pipeline would not be subject to such jurisdiction if all such gas was consumed within the state of receipt. While existing legislation -- the so-called Hinshaw provision at Section 1(c) of the NGA -- could apply in this situation, we believe it might be appropriate nevertheless for new legislation to have the same effect, without the need to meet the specific Hinshaw requirements.

CONCLUSION

MidCon vigorously opposes all sections of S. 615 which would cause the price of gas to rise to consumers. Particularly we oppose decontrol of old gas which would penalize pipeline companies with large supplies of such gas.

The provisions of S. 615 regarding pipeline purchased gas passthrough and market-out will tend to create a two-tier market for gas, which the NGPA was passed to eliminate. Interstate and intrastate pipelines would be subject to different sets of rules. Further the Bill might cause loss of gas supply thereby putting interstates in a curtailment situation. Market-out provisions will cause any producer who thinks he can get a higher price for his old gas to exercise his market-out right. The result will be total confusion on January 1, 1985, right in the middle of the winter heating season.

While we clearly have difficulty with certain provisions of S. 615, we would be willing to work with you and your staff to help ensure that the legislation does what it is intended to do: protect natural gas consumers from price increases caused by distortions in the natural gas market.

I have concentrated my comments on S. 615. However, we are reviewing all other natural gas legislation and will communicate our comments to your staff.

Thank you for the opportunity to present our views on this vital issue.

The CHAIRMAN. Mr. Abram.

STATEMENT OF JOHN C. ABRAM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SOUTHERN CALIFORNIA GAS CO.

Mr. ABRAM. Thank you, Mr. Chairman. I appreciate the opportunity to testify before you today. I also want to say that we think that it is appropriate that the legislation S. 615, has been submitted to get the process underway of dealing with the problem.

However, we are concerned about major aspects of the proposal. Southern California Gas Co. is the largest of the natural gas distribution companies in the United States in terms of customers. We serve about 8 percent of the retail customers in the United States, and close to 10 percent of the wholesale customers.

We have about 6 percent of the volume of gas that is sold in the United States. The price of gas to our customers has gone up by 2.4 times over the last 4 years in the residential area. We are faced with another $400 billion worth of increase currently.

Our charge to the commercial and industrial and electrical customers has skyrocketed on a comparable basis. If we look back 10 years, our purchase cost of gas has gone up 10 times. Our interruptable customers are increasingly switching to fuel oil which is declining in price at the same time that the cost of gas is increasing.

The shift in fixed costs on the backs of residential customers and small commercial gas users are doubly impacted as a result of this increase in gas costs.

Unfortunately, S. 615 will not accomplish the objectives of solving the problems, and the proposal as we see it will create chaos and confusion within the industry. We see that the bill would undermine the foundations of existing gas distribution and transmission industries.

It threatens supply reliability and financial stability of these industries. It would allow diversion of supplies and use of these facilities for the benefit of producers and a few large customers, but the cost would be billions of dollars that would be moved in fixed costs to the residential and small business customers.

In my view, it needlessly decontrols old gas at a cost of additional billions, and it proposes so-called consumer protections that are in fact only temporary, and, as we see it, inconsequential.

The bill would allow large gas users to raid the best of the Nation's gas supplies, the low cost old gas, that would be captured for direct sales. We will be forced to compete with our own customers and our own pipeline suppliers, and thousands of other new buyers in the gas market.

So again, residential and small business customers will be left holding the bag of high cost new gas. And our customers deserve much better than this.

We are concerned about the incentive for the mandated carriage, that is common carriage, that is proposed in this legislation. Also as we read it, it would provide not only the 5-cent increase, but it would take the other magnitude of what the transportation cost is, and remove that and flow it back to the credit of the other customers on the lines.

Old gas decontrol would cause prices to fly up very quickly between now and 1986, and notwithstanding the fact that burner tip prices are already above market clearing levels. We see that the ability to market-out and negotiate for the old gas would result in the diversion of that gas to other than to our present customers.

Also, the owners of this old gas are basically different than the new gas owners. So there is no interlinking between old gas and new gas in the decontrol process.

We see the likelihood that decontrol of old gas will produce a swift and substantial increase in the average cost of gas. In today's softening oil market, this means more load loss and more shifting of the fixed costs of the pipeline and distributor systems from our large industrial customers to our residential and small business users.

The proposal would not end regulation on the gas industry. Gas distribution and pipeline companies will continue to be regulated for the foreseeable future. Since State level regulation will always have a substantial effect on retail gas prices to consumers no matter what changes are made in NGPA, there is no way to create a free market in natural gas analogous to the free market that now exists in oil.

We urge that the views of the local gas distribution companies, which are the key point of contact between the burner tip marketplace on the one hand and the pipelines and producers on the other, be taken into account.

Our role in the functioning of the gas market really has been overlooked to a great extent by Federal energy policy makers. We have the job of serving the markets of the Nation's gas production, but we have only the most limited influence on the prices at which it is acquired.

In our opinion, the current imbalance between supply and demand reflects this influence from the burner tip. My remarks are on file in full.

The CHAIRMAN. Thank you, very much, Mr. Abram.

[The prepared statement of Mr. Abram follows:]

TESTIMONY OF
JOHN C. ABRAM
CHAIRMAN AND CEO
SOUTHERN CALIFORNIA GAS COMPANY
LOS ANGELES, CALIFORNIA

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS JOHN ABRAM. I AM CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF SOUTHERN CALIFORNIA GAS COMPANY (SOCALGAS).

I AM HERE TODAY ON BEHALF OF SOCALGAS AND THE MORE THAN 13 MILLION PEOPLE IN OUR AREA. I WOULD LIKE TO COMMEND THE ADMINISTRATION FOR OFFERING A COMPREHENSIVE AND INNOVATIVE PROPOSAL. THIS IS A VITAL CONTRIBUTION TO STARTING THE PROCESS OF FINDING ANSWERS TO THIS DIFFICULT AND COMPLEX ISSUE. HOWEVER, WE ARE VERY CONCERNED ABOUT MAJOR ASPECTS OF THIS PROPOSAL. I GREATLY APPRECIATE THE OPPORTUNITY TO TESTIFY TODAY.

INTRODUCTION

SOCALGAS COMPANY IS THE LARGEST NATURAL GAS DISTRIBUTION COMPANY IN TERMS OF CUSTOMERS IN THE UNITED STATES. AT RETAIL, WE SERVE GAS TO OVER 13 MILLION PEOPLE AND HAVE OVER 3.9 MILLION ACTIVE METERS. WE MAKE ABOUT SIX PERCENT OF THE TOTAL UTILITY GAS SALES IN THE NATION AND WE SERVE ABOUT EIGHT PERCENT OF THE NATION'S RETAIL GAS CUSTOMERS.

THE PRICE OF GAS TO OUR RESIDENTIAL CUSTOMER HAS BEEN INCREASING SINCE THE PASSAGE OF THE NATURAL GAS POLICY ACT (NGPA) AT AN EXTREMELY ALARMING RATE. THE TYPICAL MONTHLY BILL FOR A RESIDENTIAL CUSTOMER FOR WINTER HEATING IS NOW 2.4 TIMES WHAT IT WAS FOUR YEARS AGO.

OUR CUSTOMERS ARE NOW FACED WITH ANOTHER 400 MILLION DOLLAR RATE INCREASE FILING. THEY ARE JUSTIFIABLY UPSET AND ANGRY ABOUT THESE RATE INCREASES. IN DECEMBER AND JANUARY A YEAR AGO, OUR CUSTOMER SERVICES STAFF RECEIVED ABOUT 38,000 PHONE CALLS FROM

CUSTOMERS PROTESTING HIGH GAS BILLS. FOR THE SAME PERIOD THIS WINTER, THESE COMPLAINTS NUMBERED 92,000--ALSO AN INCREASE OF 2.4 TIMES IN ONE YEAR.

THE RATES WE CHARGE OUR COMMERCIAL, INDUSTRIAL AND ELECTRIC UTILITY CUSTOMERS HAVE SKYROCKETED ON A COMPARABLE BASIS SINCE 1978. IF WE LOOK BACK 10 YEARS, OUR PURCHASE COST OF GAS HAS GONE UP BY ABOUT 10 TIMES, WHILE OUR AVERAGE COST TO CUSTOMERS HAS INCREASED BY ABOUT 6.8 TIMES.

MASSIVE RATE INCREASES HAVE CREATED A DIFFICULT BURDEN ON OUR CUSTOMERS. MANY LOW-INCOME PEOPLE ARE FINDING IT HARD OR IMPOSSIBLE TO PAY WINTER GAS BILLS. OUR INTERRUPTIBLE CUSTOMERS ARE INCREASINGLY SWITCHING TO FUEL OIL, WHICH IS DECLINING IN PRICE AT THE SAME TIME THE COST OF GAS IS INCREASING. THIS FUEL SWITCHING SHIFTS FIXED COSTS ONTO THE BACKS OF THE RESIDENTIAL AND SMALL COMMERCIAL GAS USERS, WHO ARE THEN DOUBLY IMPACTED AS THE RESULT OF THE INCREASE IN GAS COSTS.

MR. CHAIRMAN, THIS SITUATION CANNOT BE PERMITTED TO CONTINUE. CONGRESS MUST CREATE A MARKET-BASED SYSTEM THAT PROTECTS ALL CLASSES OF GAS CONSUMERS, THAT ASSURES THERE WILL BE RELIABLE GAS SERVICE, AND THAT GUARANTEES THAT NATURAL GAS WILL BECOME AND REMAIN PRICE COMPETITIVE AT THE BURNER TIP WITH ALTERNATIVE FUELS.

UNFORTUNATELY, S. 615 WILL NOT ACCOMPLISH THESE OBJECTIVES. THE PROPOSAL WILL CREATE CHAOS AND CONFUSION WITHIN THE INDUSTRY, EVEN THOUGH IT WILL AID PRODUCERS AND VERY LARGE GAS CONSUMERS AND POSSIBLY MAY BE OF SOME BENEFIT TO PIPELINE COMPANIES. THERE

IS NOTHING IN THIS BILL TO HELP RESIDENTIAL CUSTOMERS. TO THE CONTRARY, THIS BILL WOULD LITERALLY COST RESIDENTIAL AND SMALL BUSINESS CUSTOMERS BILLIONS OF DOLLARS.

IF ENACTED, THE BILL WOULD UNDERMINE THE FOUNDATIONS OF EXISTING GAS DISTRIBUTION AND TRANSMISSION INDUSTRIES. IT THREATENS SUPPLY RELIABILITY AND THE FINANCIAL STABILITY OF THESE INDUSTRIES. THEIR SYSTEMS WERE BUILT, PAID FOR AND MAINTAINED OVER THE YEARS BY MILLIONS OF RESIDENTIAL AND SMALL BUSINESS GAS CUSTOMERS. BUT THIS LEGISLATION WOULD ALLOW THE DIVERSION OF SUPPLIES AND THE USE OF THESE FACILITIES FOR THE BENEFIT OF PRODUCERS AND A RELATIVE FEW LARGE GAS CUSTOMERS--AT A COST OF BILLIONS OF DOLLARS OF FIXED COSTS WHICH WOULD BE FORCED ONTO RESIDENTIAL AND SMALL BUSINESS CUSTOMERS. THE BILL EXTENDS DUAL REGULATION OVER INTRASTATE PIPELINES. IT NEEDLESSLY DECONTROLS OLD GAS AT A COST OF ADDITIONAL BILLIONS, AND IT PROPOSES SO-CALLED "CONSUMER PROTECTIONS" THAT ARE, IN FACT, ONLY TEMPORARY AND INCONSEQUENTIAL.

S. 615 WOULD BE PURE DISASTER FOR THE RESIDENTIAL GAS CONSUMERS OF AMERICA. LET ME GIVE YOU SOME SPECIFICS.

CONTRACT CARRIAGE

AS PROPOSED, THE BILL ALLOWS THE PRODUCERS AND INTERSTATE PIPELINES TO TAKE AWAY A KEY SEGMENT OF THE DISTRIBUTION COMPANY BUSINESS--THE HIGH-VOLUME INDUSTRIAL CUSTOMERS--TO THE SEVERE DETRIMENT OF THE REMAINING RESIDENTIAL AND SMALL BUSINESS CUSTOMERS, WHO WOULD THEN HAVE TO PAY BILLIONS IN FIXED COSTS FORMERLY PAID BY LARGE GAS USERS SERVED BY GAS DISTRIBUTION COMPANIES.

THE BILL ALSO ALLOWS THE LARGE GAS USERS TO RAID THE BEST OF THE NATION'S GAS SUPPLY--THE LOWER COST OLD GAS THAT WOULD BE CAPTURED FOR DIRECT SALES. UNDER THIS BILL, WE WILL BE FORCED TO COMPETE WITH OUR OWN CUSTOMERS AND OUR OWN PIPELINE SUPPLIERS AND THOUSANDS OF OTHER NEW BUYERS IN THE GAS MARKET. SO, AGAIN, OUR RESIDENTIAL AND SMALL BUSINESS CUSTOMERS WILL BE LEFT HOLDING THE BAG OF HIGH-COST, NEW GAS. OUR CUSTOMERS DESERVE MUCH BETTER THAN THIS.

THE PROPOSED $.05/MMBTU INCENTIVE TO PIPELINES TO HAUL GAS ON A CONTRACT BASIS CREATES A POWERFUL INCENTIVE FOR SOME PIPELINES TO LINE UP SUPPLIES FOR DIRECT SALE CUSTOMERS. THAT NICKEL ALSO IS A POWERFUL DISINCENTIVE FOR SOME PIPELINES TO ACQUIRE LOW-COST GAS FOR DISTRIBUTION COMPANIES. AGAIN, THE VAST MAJORITY OF THE GAS USERS IN THE COUNTRY WILL SUFFER SO THAT A HANDFUL CAN BENEFIT.

FINALLY, THE BILL WOULD CREATE A SYSTEM OF DUAL REGULATION OF INTRASTATE PIPELINES. CONFLICT, CONFUSION AND CHAOS WILL RESULT WHEN THE FEDERAL ENERGY REGULATORY COMMISSION AND THE VARIOUS STATE COMMISSIONS ASSERT SIMULTANEOUS JURISDICTION OVER THE USE OF AND RATES CHARGED BY INTRASTATE PIPELINES. THE BILL DOES NOT RECOGNIZE THIS PROBLEM, NOR DOES IT PROVIDE ANY SOLUTION.

WE THINK TITLE IV OF THE BILL WOULD BE A TERRIBLE MISTAKE FOR THE OVERWHELMING MAJORITY OF GAS USERS IN AMERICA. WE STRONGLY URGE THAT IT BE ABANDONED AS SOON AS POSSIBLE.

OLD GAS DECONTROL

THE ADMINISTRATION BILL ALLOWS THE PRICE OF "OLD" GAS TO BE RENEGOTIATED UPWARD VERY QUICKLY BETWEEN NOW AND 1985, NOTWITHSTANDING THE FACT THAT BURNER TIP PRICES ARE ALREADY AT OR ABOVE MARKET-CLEARING LEVELS.

UNDER THE PROPOSAL, PIPELINE COMPANIES AND LARGE GAS USERS WILL COMPETE WITH DISTRIBUTION COMPANIES FOR THE RIGHT TO FLOWING GAS SUPPLIES AFTER 1984, AND THEY WILL BID THE PRICES OF "OLD" GAS UP. DOWNWARD ADJUSTMENTS IN THE PRICES OF "NEW" GAS ARE, HOWEVER, HIGHLY SPECULATIVE.

NEW GAS GENERALLY WAS MORE EXPENSIVE TO FIND AND DEVELOP THAN CHEAP, OLD GAS. ITS OWNERS, WHO ARE FREQUENTLY DIFFERENT PARTIES THAN THE OWNERS OF OLD GAS, ARE UNDERSTANDABLY RELUCTANT TO REDUCE VOLUNTARILY THEIR PRICES SO PIPELINES CAN PAY MORE TO OWNERS OF OLD GAS. SO, IT IS EASY TO SEE WHY THE AVERAGE COST OF GAS WILL INCREASE WHEN OLD GAS IS DECONTROLLED.

MOREOVER, ONCE THE PROPOSED LIMITATION ON FERC PASS THROUGH OF GAS COSTS EXPIRES ON JANUARY 1, 1986, THERE WILL BE NO DIRECT PRESSURE ON PIPELINES TO OFFSET HIGHER COSTS OF OLD GAS BY ASKING PRODUCERS TO REDUCE THE PRICES THEY ARE ENJOYING ON NEW GAS.

WE SEE THE LIKELIHOOD THAT DECONTROL OF OLD GAS COULD PRODUCE A SWIFT AND SUBSTANTIAL INCREASE IN THE AVERAGE COST OF GAS. IN TODAY'S SOFTENING OIL MARKET, THIS MEANS MORE LOAD LOSS AND MORE SHIFTING OF THE FIXED COSTS OF PIPELINE AND DISTRIBUTOR SYSTEMS FROM OUR LARGE INTERRUPTIBLE TO OUR RESIDENTIAL AND SMALL BUSINESS GAS USERS.

"OLD" GAS DECONTROL TRANSFERS MONEY FROM OUR CUSTOMERS TO GAS PRODUCERS, BUT IT DOES NOTHING TO INCREASE GAS SUPPLIES. AND, IT WOULD NOT END REGULATION IN THE GAS INDUSTRY. GAS DISTRIBUTION AND PIPELINE COMPANIES WILL CONTINUE TO BE REGULATED FOR THE FORESEEABLE FUTURE. SINCE STATE-LEVEL REGULATION WILL ALWAYS HAVE A SUBSTANTIAL EFFECT ON RETAIL GAS PRICES TO CONSUMERS NO MATTER WHAT CHANGES ARE MADE TO THE NGPA, THERE IS NO WAY TO CREATE A FREE MARKET IN NATURAL GAS ANALOGOUS TO THE FREE MARKET THAT NOW EXISTS IN OIL. PLEASE BEAR THIS IN MIND WHEN YOU LISTEN TO OTHERS ARGUE THAT OLD GAS DECONTROL WILL LOWER GAS PRICES BASED ON THE ARGUMENT THAT OIL PRICE DECONTROL HAS REDUCED OIL PRICES.

CONSUMER PROTECTION

WE DO NOT BELIEVE THAT THE SO-CALLED "CONSUMER PROTECTION" FEATURES OF SECTION 101 (PURCHASED GAS COST) AND SECTION 301 (CEILING PRICES) PROVIDE MEANINGFUL PROTECTION FOR OUR CUSTOMERS.

SECTION 101 PROHIBITS THE IMMEDIATE PASS THROUGH OF PURCHASED GAS COSTS, TO THE EXTENT SUCH COSTS HAVE INCREASED AT A RATE HIGHER THAN THE RATE OF INFLATION, UNTIL JANUARY 1, 1986. WE DOUBT THAT THIS WILL DO ANY MORE THAN CAUSE A MINOR DELAY IN THE PASS THROUGH OF ABOVE-INFLATION GAS COSTS.

SECTION 301 ESTABLISHES A WELLHEAD PRICE CAP BASED ON THE LOWER OF NGPA PRICE CEILINGS OR THE AVERAGE PRICE OF GAS UNDER RECENT CONTRACTS. UNTIL JANUARY 1, 1986, THIS PRICE CAP MAY LIMIT FIRST SALE PRICES, OR IT MAY NOT, DEPENDING UPON THE PRICES PRODUCERS AND PURCHASERS AGREE TO ON NEW OR RENEGOTIATED CONTRACTS.

SECTION 301 INAPPROPRIATELY LINKS WELLHEAD PRICES TO PRICES SET IN RECENT GAS CONTRACTS. BUT, THE OBJECTIVE OF PUBLIC POLICY SHOULD BE TO ENSURE THE MARKETABILITY OF NATURAL GAS AT THE BURNER TIP. THE RELEVANT CONSIDERATION, THEREFORE, IS NOT WHAT THE COMPETITION IS PAYING IN THE FIELD, BUT RATHER WHAT THE COMPETITION (IN OUR CASE, FUEL OIL) IS SELLING FOR AT THE BURNER TIP. SECTION 301'S TEMPORARY WELLHEAD PRICE CEILINGS SHOULD BE BASED ON AND TIED TO THE PRICE OF FUEL OIL, NETTED BACK ON AVERAGE THROUGH THE DISTRIBUTION AND PIPELINE SYSTEMS. MORE IMPORTANTLY, SECTION 301 PROTECTION MUST BE EXTENDED SUBSTANTIALLY PAST 1985, IF IT IS TO PROVIDE MORE THAN A TEMPORARY RESPITE FROM THE IMPACT OF INDEFINITE ESCALATOR AND MOST FAVORED NATIONS CLAUSES.

NEW GAS DECONTROL AND THE "CONTRACTS" PROBLEM

SOCALGAS SUPPORTS THE PHILOSOPHY BEHIND THE DECONTROL OF "NEW" GAS. HOWEVER, THERE ARE SOME SERIOUS PROBLEMS WHICH MUST BE OVERCOME. WE BELIEVE THAT PRIVATE RENEGOTIATION INVOLVING PRODUCERS, PIPELINES AND DISTRIBUTORS, RATHER THAN NEW FEDERAL REGULATION, IS THE WAY TO HANDLE THESE PROBLEMS. WE AGREE THAT PIPELINES AND PRODUCERS MUST BE ENCOURAGED TO RENEGOTIATE EXISTING INDEFINITE ESCALATOR AND TAKE-OR-PAY CLAUSES. BUT THAT ALONE DOES NOT GO FAR ENOUGH. EXPERIENCE HAS SHOWN THAT IT IS NOT SUFFICIENT TO LEAVE THE PROTECTION OF NATURAL GAS MARKETABILITY TO THE NEGOTIATING EXPERTISE OF THE INTERSTATE PIPELINES. DISTRIBUTION COMPANIES WHO MUST MARKET THE GAS ARE NO LESS DESERVING OF THE RIGHT TO RENEGOTIATE AGREEMENTS WITH THEIR PIPELINE SUPPLIERS, AT THE SAME TIME THEIR SUPPLIERS ARE RENEGOTIATING WITH THE PRODUCERS. WE STRONGLY URGE THAT CONGRESS GRANT DISTRIBUTORS THIS OPPORTUNITY.

DISTRIBUTOR DISCRETION

LOCAL GAS DISTRIBUTION COMPANIES ARE THE KEY POINT OF CONTACT BETWEEN THE BURNER-TIP MARKETPLACE ON THE ONE HAND AND PIPELINES AND PRODUCERS ON THE OTHER. HOWEVER, OUR ROLE IN THE FUNCTIONING OF THE GAS MARKET HAS BEEN LARGELY OVERLOOKED BY FEDERAL ENERGY POLICY MAKERS. WE HAVE THE JOB OF SERVING THE MARKETS FOR THE NATION'S GAS PRODUCTION. BUT, WE HAVE ONLY THE MOST LIMITED INFLUENCE OVER THE PRICES AT WHICH IT IS ACQUIRED. IN OUR OPINION, THE CURRENT IMBALANCE BETWEEN SUPPLY AND DEMAND RELFECTS THIS LACK OF INFLUENCE FROM THE BURNER TIP.

UNDER EXISTING FEDERAL LAW, THE FERC ALREADY HAS AUTHORITY TO GIVE LOCAL DISTRIBUTION COMPANIES THE RIGHT TO REFUSE GAS SUPPLY INCREMENTS THAT ARE NOT MARKETABLE IN THEIR SERVICE TERRITORIES. THIS CONCEPT, WE CALL IT "DISTRIBUTOR DISCRETION," HAS BEEN PROPOSED IN SENATE JOINT RESOLUTION 46, INTRODUCED ON MARCH 2, 1983 BY SENATOR CRANSTON.

WE STRONGLY SUPPORT S. J. RES. 46 AND THE CONCEPT OF DISTRIBUTOR DISCRETION. WERE IT IMPLEMENTED, WE WOULD QUICKLY SEE A PERMANENT END TO PIPELINES PAYING PRICES FOR GAS THAT MAKE NO ECONOMIC SENSE. WE WOULD HAVE A CONTINUING, MARKET-BASED MECHANISM PROVIDING THE CORRECT PRICE SIGNALS FROM THE BURNER TIP TO THE WELLHEAD.

EXCEPT FOR SUPPLIERS OF FOREIGN OIL, NO ONE BENEFITS FROM THE DISTRIBUTORS' INABILITY TO KEEP GAS COSTS COMPETITIVE--OUR CUSTOMERS LOSE, OUR AIR QUALITY DETERIORATES, THE NATION SPENDS MORE ON IMPORTED OIL, AND DOMESTIC GAS PRODUCERS ARE DEPRIVED OF REVENUES THEY NEED TO DEVELOP SUPPLIES FOR THE FUTURE.

CONCLUSION

IN CLOSING, WE URGE THIS COMMITTEE TO MOVE FORWARD WITH A MAJOR OVERHAUL OF S. 615. THIS BILL, AS PROPOSED, WILL CAUSE PRICES TO INCREASE, NOT TO DECLINE. INSTEAD, WE NEED LEGISLATION THAT WILL ALLOW THE DISTRIBUTORS TO SEND APPROPRIATE PRICE SIGNALS BACK TO THE WELLHEAD. WE NEED A SYSTEM WHICH WILL PROTECT RESIDENTIAL AND SMALL BUSINESS GAS CONSUMERS FROM THE CHAOTIC IMPACT THAT WOULD ENSUE UPON FORCING PIPELINES AND DISTRIBUTORS TO FUNCTION AS MANDATED CARRIERS. WE NEED A BILL WHICH HANDLES THE CONTRACTS PROBLEM, RETAINS CONTROLS ON OLD GAS, AND ALLOWS US TO MOVE RATIONALLY TOWARD DEREGULATION OF NEW GAS IN AN ATMOSPHERE WHICH PROTECTS THE INTERESTS OF ALL OUR CUSTOMERS.

WE URGE YOU TO ADOPT DISTRIBUTOR DISCRETION AND THE OTHER AMENDMENTS I HAVE SUGGESTED, AND TO MOVE LEGISLATION TO THE SENATE FLOOR AS SOON AS POSSIBLE.

THANK YOU.

The CHAIRMAN. Mr. Croom, you suggested that S. 615 would not put enough pressure on producers with high-cost contracts to negotiate to lower price levels. And you concluded that the bill would result in net price increases to the consumers. The bill would permit pipelines on January 1, 1985, to abrogate those high-cost contracts. Would not that threat of abrogation provide an incentive to producers to renegotiate prior to that date?

Mr. CROOM. Senator, we do not think so. Over 75 percent of the high price gas that we buy comes from about nine major suppliers, the same suppliers for the most part that are supplying with the 104 gas.

As gas prices are today, a bird in the hand is worth two in the bush, and it is our belief that they will continue to deliver gas at the high prices today, and take their chances after that date. After all, at that point in time, the high-price gas would be worth at least what the average price of gas would be worth at that time.

Given the consideration to present value of money, of flow of gas, of the ability of producers to shut in cheap gas today and flow high-priced gas, we think that they are willing to take that risk. We do not see any meaningful negotiation between now and then over high-priced gas, unless there is some type of legislation enacted.

The CHAIRMAN. Mr. Davis, do you think that the pipelines with small reserves of old gas would receive a net benefit from S. 615?

Mr. DAVIS. Yes, sir, I do. It stands to reason under S. 615 of January 1, 1985. I agree with Mr. Croom's assessment. We have abrogation of all contracts. And it would put the companies with a large line of old gas at a distinct disadvantage. In our case, about 50 percent at that time. And I believe that a good bit of it would go to other markets.

The CHAIRMAN. As I recall, you have about 70 percent current reserves of old gas?

Mr. DAVIS. Currently.

The CHAIRMAN. Currently.

How much of your gas a year or so ago coming from Canada?

Mr. DAVIS. We had roughly 5 percent coming from Canada a year ago, 171 million cubic feet a day. And we have marketed out on that gas.

The CHAIRMAN. Did you have market-out provisions in your contract?

Mr. DAVIS. Yes, sir. We are not taking any of that. We have another Canadian contract of 75 million a day, that we have 75 percent take or pay. And we are taking 75 percent of that, which amounts to about 40 million a day. It is less than 2 percent of our total supply.

The CHAIRMAN. You are complying with contracts?

Mr. DAVIS. Yes, sir.

The CHAIRMAN. Mr. Abram, you have raised an issue that has received relatively little attention thus far in these hearings, and that is the contract carriage proposal. You state that this provision would allow large industrial users to raid the Nation's old gas supplies.

Could not the distribution companies successfully compete against the industrial users for that old gas?

Mr. ABRAM. In our view, it would open up the opportunity for a number of direct industrial type contracts with common carriers. It is questionable whether the pipeline companies or distribution companies could compete successfully with them.

The CHAIRMAN. Why?

Mr. ABRAM. What I see happening is that the producers in this interim period, rather than the pipeline companies, and the industrial customers could make arrangements, so that on January 1, 1985, that the industries could get that gas as it is free. With notification in November of 1984, on January 1 of 1985 they could have their arrangements set, and the contracts made, and the old gas would go into these direct markets.

I think that from a producer's standpoint they might find it somewhat easier to deal with a single industrial sale than the traditional method.

The CHAIRMAN. Thank you, very much.

Senator Ford.

Senator FORD. Thank you, Mr. Chairman. I only have a couple of questions. I think that you have touched on some of my problems, and I will not have to ask those questions.

But, Mr. Croom, reading your testimony, you state that some producers are forcing Columbia to accept deregulated gas, I think you said, in lieu of cheaper regulated supplies, when both are sold under the same contract.

Can FERC force producers to spread cutbacks evenly over all categories of gas; and if so, how soon?

Mr. CROOM. That is a proposal in 615, and also in 689. And it is a very strong proposal of ours, that the Congress legislate immediately to provide that multicategory contracts, that is contracts that cover old gas and newer gas and deregulated gas, be treated as separate contracts for the purpose of cutbacks.

We think that the Congress can do that. And it is the only way that we are going to get that kind of relief from producers. Producers assert with us that that is a producer right to operate their fields as they see fit.

They have refused to negotiate with us to get pro rata cutback provisions into our contracts. Some of these contracts go back to the 1960's, in which we are getting old-priced gas shut in, and new priced deregulated gas being substituted for that gas.

Senator FORD. Is Columbia a producer of gas, also?

Mr. CROOM. Columbia produces less than 4 percent of the volume that it uses. Some of that gas is old gas. Some of that gas is cost-of-service gas. But it is less than 4 percent.

Senator FORD. How many feet do you distribute daily, or what is your annual distribution?

Mr. CROOM. It has been about 1.2 trillion a year. We have distributed about 7 percent of the natural gas in this country. It is down now where it will probably be this year a little under a trillion cubic feet.

Senator FORD. A trillion cubic feet annually?

Mr. CROOM. Yes, sir.

Senator FORD. And 4 percent of that is produced by you?

Mr. CROOM. Yes, sir. That would be last year about 40 billion cubic feet by our Southwest subsidiary. This year it will be considerably less than that, because of our oversupply situation. We have shut in most of our own production.

Senator **Ford**. You have shut in your own production?

Mr. **Croom**. That is correct.

Senator **Ford**. Let me ask you this.

Have you shut back ratably?

Mr. **Croom**. We have shut it back more than we have been able to achieve with the other producers. That is my point.

Senator **Ford**. Have you shut back both old and the new?

Mr. **Croom**. That is correct.

Senator **Ford**. You have shut back both old and new.

What percentage?

Mr. **Croom**. It will be cut back about 33 percent.

Senator **Ford**. Well, is it 33 percent of old gas and 33 percent of your new gas shut back?

Mr. **Croom**. Yes, sir.

Senator **Ford**. So it is equally distributed?

Mr. **Croom**. Yes. Part of the problem is that we do not produce from any wells that are not part of reservoirs that are being produced by other producers. Most of this gas is produced offshore in the gulf. And the cutback limitations, of course, are somewhat governed by what the other producers on that particular platform are willing to do.

Senator **Ford**. How much offshore gas do you have of that percentage that you distribute?

Mr. **Croom**. Most of the gas that I am talking about is offshore. It was about 40 billion cubic feet last year.

Senator **Ford**. 40 billion?

Mr. **Croom**. Yes, sir, which is about 4 percent. It will be less than that this year.

Senator **Ford**. Mr. Davis, let me ask you a question. You heard Mr. O'Connor and his testimony, I am sure, earlier, and he gave a picture about direct sales.

What would the impact be on the residential customers in your system, I guess particularly in the Chicago area, if industrial customers had direct access to the purchase of gas?

Mr. **Davis**. I do not think that there is a question, Senator, but that it would increase the cost of gas to the household consumer. I share Mr. Abram's views that, with the direct sale to large industrials, this would be market loss by the local utility, and spread the unit cost over its residential consumers much to their disadvantage.

Senator **Ford**. I think that the problem here is that not many people understand unit cost. And we need, I think, at some point to spread on the record what we understand to be a unit cost, whether it is your unit, or Columbia's unit, or somebody else's unit cost.

And I think that that percentage, in how it is factored, is important.

Under 615, Mr. Davis, if I understood you right, you said that 70 percent of your reserve is old gas, and then 30 percent of that, then, to make the 100 percent, would be new gas or new-new gas?

Mr. **Davis**. We have a mix currently. It is about 70 percent old gas, and about 2 percent new-new gas, the 107 gas, that is the unregulated gas. And then about 28 percent of 102 and 103 gas.

Senator FORD. Under this legislation, if there is a pipeline with you, and if their percentage was reversed, they had not exercised prudent management and foresight that you had, so they wound up with a large percentage of higher-cost gas and a lower percentage of low-cost gas, so-called, completely regulated gas, would you be placed at a disadvantage then, and they would be placed at a great advantage, because your 70 percent would be deregulated, and only 30 percent of theirs?

Mr. DAVIS. Yes, sir. I do not think that there is a question but that we would be disadvantaged. In 1985, we estimate that our mix of old gas at that point would be about 50 percent. This is something that you literally work your way out of by 1990 in any case.

And doing deregulation of old gas prematurely will put us in a position that we will have to acquire or bargain for a large percentage of our gas that is going to increase in price. And with the foolproof provisions, of course, passing costs through, we are in a position that we have to deal with the FERC, and put ourselves at great risk on that which we do pay the higher prices for with no assurance that we get recovery costs.

And I feel that we have always been prudent purchasers. But prudence then would certainly be the governing factor.

Senator FORD. Something bothered me this morning about Mr. Butler's testimony, where we say that the consumer protection provisions in the legislation, 615, that they were allowing a price for pipelines plus inflation, and that is it regardless. You would have to eat whatever you had to pay over that.

Yet Mr. Butler came before us this morning, and in his statement he was talking about providing some way for pipelines to recover the cost in excess of the allowed rate. Maybe he was touting you a little bit to come along, and maybe support this legislation. FERC is already talking about finding a way that you could recoup that cost.

That is talking out both sides of their mouth, I think, as far as supporting this legislation. The big thrust here is protecting the consumer. The fellows who have been doing it as long as you have understand it a whole lot better than those who are writing this legislation.

Mr. DAVIS. We feel like we have been doing it all along, Senator.

Senator FORD. I understand that. And if a fellow has 70 percent low gas in his pipeline, he is doing one hell of a job. And with my bell going off, I will stop.

The CHAIRMAN. Thank you, Senator Ford.

Senator Hecht.

Senator HECHT. Mr. Johnson, you advocate the decontrol of old gas. You, therefore, part company with most of the other distribution companies, which are strongly opposed to decontrol of old gas.

What is, in your opinion, the fundamental reason for your position on decontrol?

Mr. JOHNSON. Senator, we believe that decontrol of old gas will lead to the lowest prices accompanied by an adequate supply over time. I think, also, that there is no question that in our market area, decontrol would lead to lower prices almost immediately.

We have the disadvantage of buying from two fairly high-cost intrastate pipelines who have already begun the battle to get their gas costs down. As I mentioned before, their gas costs are coming down.

We are also served by one of the highest-cost interstate pipelines in the country. And we think that decontrol would tend to force down the prices paid by that pipeline.

Senator HECHT. Do current market conditions have a part in your thinking?

Mr. JOHNSON. Yes, we think that the ideal time to go to decontrol is when the supply exceeds the demand, and does so in a dramatic way. And we question whether there will be as favorable a time in the future as there is right now.

Senator HECHT. Just to put you on a spot even more, give a prediction of how much, percentagewise in the next 6 months prices will come down.

Mr. CROOM. In the field, or in the market?

Senator HECHT. The market.

Mr. JOHNSON. Under current conditions without any further legislative action, I would expect in the intrastate market our prices to decline 20 to 30 cents, which would be in the range of 6 to 7 percent. And I think that this is a result of deteriorating conditions in the market at the wellhead plus competition between various pipelines.

Senator HECHT. I appreciate your frank answers. Let us go down one step further.

What about a year from now?

Mr. JOHNSON. Again answering for the intrastate pipelines, I look for a continued decline in the price of gas from our intrastate pipeline suppliers. And I would think that by this time a year from now we would see a reduction of probably on the order of 40 cents, which would be roughly 10 percent.

Senator HECHT. Thank you, very much.

I have no further questions, Mr. Chairman.

The CHAIRMAN. Thank you, very much, Senator Hecht.

Senator Metzenbaum.

Senator METZENBAUM. Let me ask a question, and I think that I know the answer.

Mr. Croom, you are against the bill in its present shape?

Mr. CROOM. That is correct.

Senator METZENBAUM. And Mr. Johnson?

Mr. JOHNSON. Yes.

Senator METZENBAUM. Mr. Davis?

Mr. DAVIS. Against.

Senator METZENBAUM. And Mr. Abram?

Mr. ABRAM. Yes.

Senator METZENBAUM. Let me ask you each the other question that I asked the other witnesses.

Would you favor total decontrol, Mr. Croom?

Mr. CROOM. Philosophically, I do favor it, but I do not see any way in getting from here to there in any present legislation or proposed legislation.

Senator METZENBAUM. Mr. Johnson?

Mr. JOHNSON. We do favor decontrol, Senator.

Senator METZENBAUM. And Mr. Davis?

Mr. DAVIS. We favor ultimate decontrol, but we are opposed to giving our chief oil supplies. And we think that this provides an easy phasein without great shock to the consumer.

Senator METZENBAUM. Mr. Abram?

Mr. ABRAM. We are against decontrol of old gas. We philosophically, like Mr. Croom, favor decontrol in the long term. It is going to be difficult to get there, I can tell you.

Senator METZENBAUM. Let me ask you another question. I have difficulty in my next part of my question because, frankly, I am on your side, but I do not know how you can be where you are. I can better understand my own rationale for being there than I can yours

Because each of you is sitting there saying to us that there ought to be legislation, that Government ought to interfere with contracts that have already been negotiated, take-or-pay contracts, escalator clauses in contracts, market-out clauses in contracts.

And what is bothering me is how each of you—I do not know what your politics are, but I assume that you are conservative, staunch, economic loyalists of one kind or the other—how do you come out saying that you now want the United States Government to come in and give you the right to break a contract.

To me, that is just so foreign to anything that all of you have stood for all of your lives. And I have difficulty in understanding how you can say, "Government, help us get this relief."

Mr. CROOM. I would like to address that, Senator.

Senator METZENBAUM. Be my guest.

Mr. CROOM. Thank you.

Columbia has not really bought any gas, and has not entered into any new contracts for over 2 years to buy new gas other than honoring some earlier commitments that were already in process. The bulk of the gas that is flowing to us today is under relatively old contracts. Many of these contracts predated the Natural Gas Policy Act of 1978.

No one at that time anticipated pricing categories. No one anticipated oil prices going to the prices that they did. In fact, when the act was being developed, and prices were being speculated, $15 by 1985 for a barrel of oil. We all know what has happened there.

The circumstances which have permitted this gas that was under contract was largely a result of shortages that we saw back in the 1970's. And now we are looking at price distortions which are the result of a number of factors.

Certainly the act in 1978, I am sure resulted from those shortages that we saw in the 1970's. What we are seeking now is to put the market and the production of gas back into some balance. And some of that distortion results from 1978.

Senator METZENBAUM. Mr. Croom, I only have 10 minutes, and I have to get to a point.

If you entered into a lease arrangement to lease three floors of a building in Columbus, Ohio, or if you agreed to buy 200 automobiles, you would have to buy them, even though the price of those cars went down, or the price that you could rent the real estate when down, when the market went down.

How do you come to the Congress, and say to Congress, "we have got a bad contract, please let us out." You have already gone to

FERC, and said: "we have got a bad contract, let me pass it on to consumers," which, as you know, I find to be a totally inappropriate procedure.

Now I am asking you, how do you rationalize in your own mind asking Congress to break a contract with whomever the producer is?

Mr. CROOM. Well, to take your example, if I had a contract with an automobile supplier to fulfill my needs, and to give me automobiles over a period of time, and then subsequent to that there was interjected into that some type of a provision that said that I had to take so many small cars, and so many of medium priced, and larged priced, I would not be coming out and controlling the market situation or needs that I had anticipated when I sat down with that producer. That is where we find ourselves today.

Senator METZENBAUM. Are you not in the last analysis saying, "Congress, we made a bad contract. Help us get out of it." Is that not really the bottom line?

Mr. CROOM. I am saying that as a result of circumstances in the whole industry, the act of the Congress, the international energy situation, that it has brought us to a point that is unacceptable to industry and consumers. And we are asking for relief.

Senator METZENBAUM. I am on your side on getting out of these contracts. But what bothers me is the whole question of the contract, of the obligation to live up to your contract, which to me is a very basic principle of the whole system of the marketplace in which we operate.

If I make a bad contract, I have got to live with it. You are saying we do not like Government to interfere with our business. But in this instance, well, it is different. You have got to help us out.

Mr. Abram, Mr. Johnson, Mr. Davis, I have got about 4 minutes left, if any of you care to address yourself to that question, which bothers me much. I will tell you that on the vote, I will be with you. But I must tell you that I also have some concerns about how you get there, and how I get there.

And I am not talking about its legality, because I think that it is legal under Supreme Court decisions. But I am not sure that it is right.

Mr. DAVIS. Senator, speaking for our system, we can live with NGPA as it is. We think that direct negotiations with suppliers is the way that it should be done. If you are going to do it legislatively, these are the things that we suggest, what I have presented in my testimony.

Senator METZENBAUM. Mr. Johnson.

Mr. JOHNSON. Senator, I feel that the contracts containing indefinite price escalations were entered into on the assumption that old gas would be continued to be controlled. And frequently on the assumption that the clauses would never come into operation.

So I think that it is appropriate for Congress to do something about it, if it is going to change the basic assumption about how gas is regulated.

Senator METZENBAUM. Mr. Johnson, you could have put that clause in your contract. You paid your lawyers a lot of money to draw those contracts. They could have said: "Provided, however, That if Congress does this or does not do that, then something will result."

Now you have got a contract, and you are telling us let us break our contract.

Mr. **Johnson**. Well, of course, we are a distributor, and not a pipeline. But I have seen some of those pipeline contracts, and they are already too long. And I do not think that it would be prudent to anticipate every circumstance which could conceivably arise.

But I also feel that there are many areas in which Congress acts to insure of an operation to assure the operation of a free market. And that is what I visualize Congress would be doing, if it took action against indefinite price escalation clauses.

Senator **Metzenbaum**. The free market does not include breaking contracts. That is not a free market. I mean you are asking us to let you break your contracts.

Mr. Abram.

Mr. **Abram**. The proposal before you asks to break contracts, and breaks every contract, every single contract, between producers and pipelines.

Senator **Metzenbaum**. That does not make it any better.

Mr. **Abram**. And there are those of us who are saying what you are going to do, if you do that, is create absolute chaos. You are going to undermine the whole financial arrangements that have been made between pipelines and financers, between distributors and their financers.

But there is one thing that many of us, at least on the distribution side, have contracts which involve volumes of gas which would flow on back through FERC regulation. There have been affected by regulation repeatedly over the years and over the terms of those contracts.

If we go back to 1954 when wellhead price controls were introduced, we have gone through a whole series of changes, leaving to area rate price controls in the early 1960's and all the way through. So we have gone through repeated Federal Government changes. And in 1978, the NGPA was passed.

Senator **Metzenbaum**. Those changes were made on the basis of two parties negotiating, not on the basis of Government vitiating a contract, right?

Mr. **Abram**. They negotiated after the rules were set by the Federal Government. And what you are looking at here, and what I think that you risk, is either modifying some of the conditions that exist today, or going back to recontrol, which I do not think any of us would favor.

Senator **Metzenbaum**. One last point to you, Mr. Croom. You answered Senator Ford's question that you only use 4 percent of your own production. I have before me a report entitled "Competition Issues for Integrated Natural Gas Pipelines," by Mr. Robert Portman for the Division of Energy Deregulation, Office of Policy, Planning, and Analysis, U.S. Department of Energy, October 5, 1982.

And they indicate a totally different figure. They indicate that pipeline purchases from producer affiliates, and they indicate that you use 10.2 percent.

Are they wrong?

Mr. Croom. Some of that gas is cost of service gas, Senator. And we were talking about what the pipeline was buying from its affiliate. I believe that I answered the Senator in terms of our Southwest affiliate.

Senator Metzenbaum. What Senator Ford was asking you, and what is the real issue is, is how much gas that you are using are you buying from yourself. And this says 10.2 percent. And I think that your answer to Senator Ford indicated 4 percent.

Now which is right?

Mr. Croom. Senator, there are two parts. The pipeline company in the Appalachian area produces some old gas, some tight sands gas. It also buys some gas from its Southwest subsidiary, or affiliate, that is. And that gas represents about 4 percent of the volume that I was talking about.

In the Appalachian area, that other gas would represent the balance of that. 10 percent, I am not sure what year you are talking about. But there is pipeline production gas in the Appalachian area. That is correct.

Senator Metzenbaum. The 10 percent is right?

Mr. Croom. I am not sure for what year you are talking, Senator.

Senator Metzenbaum. Well, let me see if I can tell you.

Mr. Croom. This year it is going to be substantially less than that.

Senator Metzenbaum. I think that it is 1982, if I am not mistaken. Well, it cannot be 1982, I am sorry, because the report was prepared in 1982. But it certainly is not an ancient report. It was probably 1981, I would guess.

Would that 10.2 figure be more accurate?

Mr. Croom. Subject to check, I would think that that might be near the number, Senator. But it includes cost of service gas. That is my point. Old cost of service gas.

Senator Metzenbaum. But that does not matter. I do not think that the Senator's question made any difference. He was just wanting to know how much of the gas that you are buying and that you are using is your own gas, the gas that you are buying from ourselves.

Mr. Croom. And I was attempting to make a distinction between cost of service gas and the other gas under NGPA.

Senator Metzenbaum. Thank you.

Senator Ford. Mr. Chairman.

The Chairman. Senator Ford.

Senator Ford. Have you not closed in or closed out your Appalachian supply?

Mr. Croom. We are shutting it in to the same extent that we are shutting in other production that we buy in the Appalachian area.

Senator Ford. Not to the same extent as the other 4 percent?

Mr. Croom. I am sorry, Senator.

Senator Ford. I do not believe that it is to the same extent as the other 4 percent, as you answered my question earlier.

Mr. Croom. We are shutting in production up to 6 months out of a year in the Appalachian area. And we are cutting our own production end to the same extent of the gas that we buy in the Appalachian area.

Senator Ford. Thank you.

The Chairman. Senator Domenici.

Senator Domenici. Thank you, Mr. Chairman.

Mr. Johnson, you indicate in your prepared remarks that while you prefer decontrol, you believe that a compromise between the, as you put it, the partisans of complete decontrol and the status quo, or perhaps even recontrol, is highly desirable.

And then you suggest some things that are happening within your jurisdiction that I am interested in. You indicate that there is some significant renegotiation occurring.

Can you quantify that?

Mr. Johnson. Well, yes. I think generally that purchasers of tight gas, who have been paying $5.44, I believe, plus severance are now saying that they will pay $3.30, which would be the current 102 price. Deep gas, also, is coming down, although some pipelines are still willing to still pay more for deep gas than market clearing levels, which again has to be the result of the impact of the old gas cushion on their decisions.

I have seen contracts recently in which gas has sold at as low as $2.25 to as high as $3.30. And I believe that a great deal of gas presently could be purchased provided that the purchaser could give assurances about takes at $2.75.

Senator Domenici. You also indicate that at the present time, you have evidence that some pipelines are willing to breach contracts on grounds that until recently would have been thought novel.

What does that mean?

Mr. Johnson. Well, we have seen several pipelines breach contracts. I am probably assuming a legal conclusion when I say breach. But they have ceased to perform under contracts on the grounds of economic force majeur. Those are relatively new concepts, and that was what I was referring to.

Senator Domenici. But regardless of whether it is a novel breach or not, is it working?

Mr. Johnson. It is producing lower prices. And our view is that we cannot tell our pipelines how to operate. We can only tell them that they need lower prices, and to communicate the message of the marketplace to our pipeline suppliers. And it is up to them to discover novel theories, which will allow them to live with those markets.

Senator Domenici. You also indicate that take or pay provisions are a problem for some pipelines, and then you indicated in your statement that, as many of us may know, that the Texas Railroad Commission has approached that a little bit differently. And you spoke of a Commission order directly pro rata takes notwithstanding take or pay provisions.

Mr. Johnson. Yes.

Senator Domenici. Can you explain that to the committee?

Mr. Johnson. Well, basically, the Railroad Commission has an order that is applicable to all of the pipelines that it regulates. And it provides, in order to prevent drainage, that pipelines will take pro rata from their various producers.

For example, a pipeline that only needs a certain quantity of gas would first determine the amount that was necessary to prevent well damage, that would be casing head gas. And the remaining quantity would be divided pro rata among all producers.

And it might be, and is right now, in the case of several intrastate pipelines 20 percent. There is one intrastate pipeline, we understand, that has rolled all of its producers back to zero, but is taking casing head gas.

Senator DOMENICI. I assume that we could get from the State of Texas what this pro rata has done to various prices of gas as it has pushed the pro rata down, could we not, in quantities?

Mr. JOHNSON. I assume that that information is available. The pro rata, of course, occurs without respect to price.

Senator DOMENICI. I understand. But obviously wherein, the problem is assumed to be significant portions of high priced take or pay in a glut market, and that you would have some information as to how effective pro rata might be as an instrument for reducing large quantities of very high priced gas that might be in pipelines.

Let me ask you another question. You indicated at one point that producers need relief for low prices under the NGPA, you said imposed on old gas. And then you went on to indicate that what I read here that there must be substantial quantities in your opinion of in-field drilling that is being left unattended, and certainly resources not going into that, because of the low price.

How much do you know about that?

Mr. JOHNSON. Well, I cannot give you any figures, but I have had a number of discussions with producers. And I am aware that any time that they are drilling into a formation that has an old gas price on it, that the automatic reaction is that we do not drill, we look for something else.

I think that if we keep the controls on old gas forever, we are going to leave a lot of gas in the ground that otherwise would be produced. And we may have to go back, if we continue controls, to some kind of stripper type pricing, such as we had in the case of oil in order to get that gas out of the ground.

Senator DOMENICI. Well, you have given a few ideas in this part of your presentation as to compromises. I have not read it carefully.

But what is your compromise with reference to old gas?

Mr. JOHNSON. My suggestion would be that old gas be decontrolled over a 2- to 3-year period as a compromise suggestion. That could be done with a number of techniques. Some of them have been discussed in the past. I will not go through all of those.

It would also be possible, I supsect, to fix a date certain, and continue the controls on old gas for the next 2 or 3 years, and on a date certain completely decontrol, somewhat in the fashion of S. 615.

I think that our greatest criticism of S.615 in this regard is that by putting limits on pipeline PGA's, it impairs the ability of the market to react to that situation. It says that the producer can charge more for his gas, but the pipeline cannot pay it.

And in our judgment, that is not going to get us to decontrol.

Senator DOMENICI. Let me ask the California representative. Some indication was given to the committee about the concern that industrial users in the future might go into the old gas market with some common carrier aspects built into the pipeline system, and might go and buy it cheap and get it carried for them, and thus have an adverse impact on the consumers, residential consumers, and the like. Let me ask the reverse.

Is the Fuel Use Act and its limitations having a significant impact now on the price of gas to residential users, as you view it?

Mr. **ABRAM**. Yes.

Senator **DOMENICI**. So you support getting rid of the Fuel Use Act, so as to increase industrial demand, and I assume to get rid of incremental pricing, so that the industrial use will have the appropriate effect on residential that is real as contrasted to what we assumed in the act.

Is that correct?

Mr. **ABRAM**. No, I do not think that that is what we are saying. What I am saying is that if the industrial customers come in——

Senator **DOMENICI**. I understand that.

What I am saying is what good would getting rid of the Fuel Use Act do to you, why would it help in incremental pricing?

Mr. **ABRAM**. For us in California, incremental pricing has not been a major issue just because of the way that our pricing structure has been. Getting rid of the Fuel Use Act in the long term, if there is a supply, allows one to serve that supply within that market area. We have had a major portion of our total sales over the years going to industrial and electric generating type customers.

We have almost 50 percent of our total volume of sales going to those that are interruptible and who can switch to fuel oil.

Senator **DOMENICI**. Does that have a positive effect on what you have to charge the home user?

Mr. **ABRAM**. Yes, it has been beneficial in sharing the costs of the system.

Senator **DOMENICI**. So the theory in the national law that incremental pricing would have the reverse effect is not true, although incremental pricing has not been a problem to you. The theory of incremental pricing was we will make the industrial user pay more, and curtain him so that we will have more for residential, but yet the opposite effect occurs.

Mr. **ABRAM**. It has had the opposite effect in other parts of the country. Today we are facing up to a problem where retention of our industrials is coming under extreme competition. For a period of 1 month, we lost sales of roughly 700 million cubic feet per day until a restructuring of rates for the electric generating plants took place. A shift of a large number of dollars normally recovered from the industrials has been made or is being made to the residential customers.

Senator **DOMENICI**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you.

Senator Melcher.

Senator **MELCHER**. Mr. Croom, is it Columbia's position that the NGPA is good enough, or are you asking for some modifications?

Mr. **CROOM**. We think that the NGPA in itself has certainly demonstrated that more gas can be produced, and the incentive can be provided to increase the gas production. We are not asking that NGPA, title I, be reopened in terms of decontrolling old gas.

What we are asking specifically is that certain contract provisions be addressed that are permitting gas prices today to not respond promptly to market conditions. And I have ennumerated a number of those, such as market-out provisions, indefinite price escalators, et cetera.

Senator MELCHER. Are your seven points here all legislative points?

Mr. CROOM. That is correct.

Senator MELCHER. They are all modifications of the NGPA then?

Mr. CROOM. Yes. And those seven points are for the most part included in S.689. The one provision that is included in our proposal that is in 615 that is not in 689, and we would think should be considered as a part of 689, would be that provision to treat the separate contracts, that is to provide a pro rata cutback of multicategory gas.

That is the one point that I find is deficient in 689.

Senator MELCHER. That would be your point No. 2?

Mr. CROOM. I do not have those before me.

[Pause.]

Mr. CROOM. Thank is correct.

Senator MELCHER. Thank you, very much, Mr. Croom.

The CHAIRMAN. Thank you.

Mr. Croom, you addressed the question of renegotiation of the contracts, the existing contracts, and you have attached to your testimony a list of the producers with whom you have been able to renegotiate some of the provisions, particularly take-or-pay provisions.

As I read your tesimony, you referred to volumes rather than prices.

Mr. CROOM. That is correct. That list refers to the success that we have had with producers in addressing just one contract element, and that has to do with take-or-pay.

The CHAIRMAN. Take-or-pay volumes or the price?

Mr. CROOM. Well, it is take-or-pay by percentage. But when we started out, some of those take-or-pay provisions were as high as 90 percent. We were successful in getting producers to reduce that down to 75 percent of those volumes representing about 60 percent of the volumes that we purchased during any given period of time.

The CHAIRMAN. But the contract price for those volumes did not change?

Mr. CROOM. That is correct. And we have gotten no cooperation toward any price renegotiation.

The CHAIRMAN. Have you tried to renegotiate price?

Mr. CROOM. Most definitely. And I think we had a letter exhibit included with my testimony.

The CHAIRMAN. Mr. Johnson, what success have you had in renegotiation attempts, if any?

Mr. JOHNSON. Well, you must understand that we are a very limited purchaser from producers. We had to purchase gas directly from producers a number of years ago in order to offset the impact of curtailment from our pipeline suppliers. But other than that, we do not make major purchases. Sometimes we work with pipelines in making those purchases. Basically, we do not have any to renegotiate.

The CHAIRMAN. Have you asked the pipelines that supply you if they had renegotiated?

Mr. JOHNSON. Yes, we have.

The CHAIRMAN. And what do they report to you?

Mr. JOHNSON. Well, I would say that so far they report little success. In the case of our largest interstate supplier, the problem has been to a large degree Canadian gas. And we are aware that our supplier has tried to renegotiate that price down, but has not been successful.

The CHAIRMAN. Is it under a take-or-pay contract?

Mr. JOHNSON. It is my understanding that it is. And that one of those novel defenses has been asserted to that.

The CHAIRMAN. Mr. Davis.

Mr. DAVIS. We have been able to manage our contracts within the take-or-pay provisions within them. Up to this point, we are in the process, however, of attempting to negotiate downward the take-or-pay requirements. We have had no success on price.

The CHAIRMAN. Mr. Abram.

Mr. ABRAM. We have discussed this with our major out-of-State suppliers. They have, as I understand, made some attempt to renegotiate. They have marketed-out on some of their 107 gas. And both of those suppliers are El Paso and TransWestern.

We have a small amount of gas coming from Canada. And there are negotiations going on with Canada almost daily. The last report that I got was as of last evening. There is some hope of reduction of both take-or-pay and the price as well. The discussions are being held with both the provincial producers and the Federal Government.

The CHAIRMAN. Mr. Johnson, you mentioned that there are some supplies of gas available below those take-or-pay contract prices in the market today. I think that you also conditioned that upon if you are able to give volume assurances.

Mr. JOHNSON. Yes.

The CHAIRMAN. Are we in a different round of take-or-pay negotiations?

Mr. JOHNSON. No. I think that what has happened—you see, there is a tremendous variation in the intrastate market among pipelines. Some have, I think, done as good a job as possible given the handicap that they operated under under the NGPA.

They have kept their prices as low as possible. They have kept most of their markets. And they are therefore able to assure producers of takes in the 60 and 70 percent range.

As a result, that allows them to enter into new contracts, and to buy cheaper gas, because they can assure people of pretty good takes. A pipeline that is cut back to 20 percent or to zero is not going to be able to do that.

The CHAIRMAN. Mr. Croom, Senator Domenici had asked earlier some questions about the Texas Railroad Commission order for proportional reductions in volumes.

Have you had any experience with that?

Mr. CROOM. No, we have not. Just about all of the gas that we buy comes from onshore-offshore Louisiana.

The CHAIRMAN. Would you believe that is a useful or workable provision?

Mr. Croom. Well, I am not familiar with it. But if we find that there is a way that we can apply it, we certainly will.

The Chairman. Mr. Abram.

Mr. Abram. I am not familiar with it at all. It has not been an issue in our California situation.

The Chairman. Thank you, very much, gentlemen. I appreciate your testimony here today, and we will appreciate your responses to written questions when submitted.

[Subsequent to the hearing Mr. Johnson submitted the following:]

ENTEX

Wayne D. Johnson
PRESIDENT

MAR [illegible] 1983

Official Committee File

March 29, 1983

SENATE COMMITTEE ON
ENERGY AND NATURAL RESOURCES
RECEIVED
APR 4 1983
WASHINGTON, D.C. 20510

Honorable James A. McClure
United State Senator
3121 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator McClure,

During the question period following my testimony before the Senate Committee on Energy & Natural Resources on March 12, 1983, several questions were asked by you and Senator Domenici concerning the operation of the Texas proration system. I have taken the liberty of forwarding a copy of the Texas Rule and a summary of the same to both you and Senator Domenici for any assistance it may provide in your deliberation.

Very truly yours,

Wayne D. Johnson

WDJ:wh

Enclosures

ENTEX, INC., P.O. BOX 2628, HOUSTON, TEXAS 77001, (713) 654-5560

SUMMARY OF TEXAS RATABLE TAKE RULE

The Ratable Take Rule, 16 T.A.C. §3.91 (a copy of which is attached), provides that a purchaser proportion its takes from producers in a manner to prevent discrimination as between producers within a field and to prevent unjust or unreasonable discrimination as to producers in different fields. The Ratable Take Rule is based on §§ 111.081-111.097 of the Texas Natural Resources Code, whose purpose is, in part, to protect the correlative rights of the interest owners in gas within a particular field.

The Ratable Take Rule requires producers, "initial purchasers", and "downstream purchasers" to prepare and file estimates of their actual demand for gas. These projections of market demand for gas are filed with the Railroad Commission to allocate a limited market demand and establish allowables for gas wells. The producer files a forecast (Form G-7) which shows the expected market demand for the gas, plus any gas which the producer expects to use. The market demand figure is supplied to the producer by the purchaser. The "first purchaser" files a nomination (Form T-3) showing its expected demand for the gas. The purchaser's nomination is based on projections received from downstream purchasers (either on a monthly or yearly basis, depending on the quantity of gas used by the downstream purchaser).

The Ratable Take Rule requires the purchaser to total its need for gas and ratably apportion its nominations, as reported on Form T-3. The specific provision of the Ratable Take Rule reads as follows:

> (5) The initial nominator of gas shall ratably apportion its nominations on Form T-3 and shall ratably apportion its actual take from all gas wells connected to its system so that takes from various gas producing properties shall be made without discrimination in favor of one producer or person as against another in the same field and without unjust or unreasonable discrimination as between fields. The following instructions shall apply to initial nominators in preparing nominations (Form T-3) and in taking gas from various sources of supply, and to the commission's staff in calculating allowables:
>
> > (A) Nominations shall be based on each well's deliverability as reflected by the well's Form G-10 on file with the commission. Actual

takes shall be based on the commission's assigned allowable for each well, with proper recognition for special allowable wells and limited capacity wells.

(B) First priority in the nomination for the purchase of gas shall be given to casinghead gas and second priority to Statewide Rule 49(b) gas so that gas produced in association with oil production shall not be wastefully vented and oil production shall not be unnecessarily curtailed. Under special circumstances, if market demand factors or temporary pipeline, compressor, or other operating difficulties result in less take from a Rule 49(b) gas well than its permitted allowable, then by special commission authority such underproduction may be carried forward and balanced as would be the case for any other gas well, provided, however, that no Statewide Rule 49(b) gas well may be allowed to overproduce its permitted allowable by a cumulative total in excess of one month's allowable.

(C) No gas well of any kind shall be given an allowable in excess of the capability to produce.

(D) Each new gas well operated under §3.28 (05.1.02.02.028) of this title (relating to Potential of Gas Wells To Be Ascertained and Reported) (Statewide Rule 28) and §3.29 (051.02.02.029) of this title (relating to Production of Gas Limited to 25% of Potential Capacity) (Statewide Rule 29) shall be assigned an allowable not to exceed the deliverability test volume as reported on Form G-10.

(E) Actual takes from a limited capacity well in a prorated field shall not be reduced to less than its capacity to produce unless all wells in the same field with capacity to produce exceeding that of the limited capacity wells have had their actual takes ratably reduced to the level of such limited capacity well. Texas Natural Resources Code §86.091 shall control the minimum takes from gas wells.

In practice, many purchasers total the expected market demand, and subtract a volumetric figure representing the total deliverability of gas produced from wells for which there are priorities (casing head, Rule 49(b) gas, etc.). The remaining market demand is then apportioned ratably among other wells, which are commonly referred to as "swing gas". This is done by dividing the remaining market demand by the total of the deliverability (as shown on Form G-10) for the swing gas wells to determine a percentage. The deliverability for each swing gas well is then multiplied by the percentage figure to determine the nomination for each swing gas well. Through this process, the purchaser has divided the expected market demand for swing gas equally among all the swing gas wells.

The Railroad Commission utilizes the nominations filed by the purchasers and the forecasts filed by the producers to determine the allowables for each well. If there is more than one well in a field and more than one purchaser, the allowables will not necessarily equal the expected market demand and often be a compromise. In other words, the allowable will balance the nominations within a field to protect the correlative rights of the interest owners. For example, if there are two wells in a field and two purchasers, one purchaser may nominate 100 percent of the deliverability of a well and the other purchaser may nominate 20 percent of the deliverability of the other well. The allowable established by the Railroad Commission may be set at 60 percent of the deliverability of the wells. In the process of setting allowables, the Commission takes into account various other factors, including, but not limited to, past over or under-production.

If each purchaser could take exactly the allowable from each producer, it would simplify matters. However, due to various reasons, the daily takes will be either over or under the allowables. Pursuant to the Ratable Take Rule, the purchaser must adjust its takes so that they are made without discrimination in favor of one producer or person as against another in the same field and without unjust or unreasonable discrimination as between fields. In general, many purchasers simply request the producers of swing gas to increase or lower the production rates of the swing wells by a percentage figure (usually of allowables) in order that the takes remain ratable.

dation is adverse to a party in the docket, a proposal will be issued. Exceptions to the proposal may be filed within 13 days after service, and replies to exceptions may be filed within 18 days after service. Exceptions and replies must be served on all other participants and be received by the commission within these times in order to be considered.

(f) Dockets will be consolidated if practicable for presentation of the examiner's recommendations to the commission.

(g) If a person alleging a justiciable or administratively cognizable interest was not given notice, a written motion in intervention may be filed by the date of commission consideration in open meeting showing good cause for the commission to grant the intervention or take other appropriate action.

(h) Motions for rehearing may be filed within 15 days of an order. A reply thereto may be filed within 25 days of the order. Motions and replies must be received by the commission within these times in order to be considered.

(i) Within five days after the last day for filing a motion for rehearing or, if such a motion is filed, within 15 days after it is denied or overruled by operation of law, the commission will transmit to the FERC a copy of its determination, together with the record and any additional material required. Notice of the transmittal will be given to the applicant, nonoperators, and, in the case of section 108 determinations, to the purchaser(s).

(j) If a determination is reversed by the FERC, an applicant may file a new application based on additional evidence. If a determination is remanded by the FERC, notice will be sent to all parties, and a hearing will be scheduled if required.

Authority: The provisions of this § 3.84 issued under Acts 1977, 65th Leg., ch. 871, art. I, effective September 1, 1977, as amended (Natural Resources Code §§ 81.001 — 113.234).

Source: The provisions of this § 3.84 amended to be effective April 25, 1980, 5 TexReg 1418.

MISCELLANEOUS

§3.91 (051.02.99.001). Gas Market Demand, Allocation of Gas Well Allowables, and Ratable Take between Gas Wells and Gas Fields.

This section supplements, but does not amend or repeal any existing commission rule.

(1) The following definitions are applicable to this section:

(A) *First purchaser* — One purchasing natural gas from a producer.

(B) *Downstream purchaser* — One purchasing natural gas for resale from other than a producer.

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(2) The producer's forecast (Form G-7) and the purchaser's nomination (Form T-3), both required by §3.30 (051.02.02.030) of this title (relating to Gas Nominations Required) (Statewide Rule 30), shall be utilized in arriving at the actual demand for gas from all gas producing fields in the State of Texas.

(3) Operators of gas wells (producers) shall submit the following information, depending on the type of gas field in which the gas wells are completed:

(A) For those gas fields with special field rules which establish gas allocation procedures (prorated), the producer shall furnish the following:

(i) Form P-4, producer's certificate of compliance (on which the gatherer, the first purchaser, and the initial nominator shall be named).

(ii) Form G-10, gas well status report (semiannually unless otherwise required by the special field rules).

(iii) Form G-7, producer's forecast (monthly as required by §3.30 (051.02.02.030) of this title (relating to Gas Nominations Required) (Statewide Rule 30) and in accordance with instructions on Form G-7). Each producer shall forecast a total quantity of gas not to exceed the amount of gas the producer expects to consume *(e.g.,* for compressor use, cycling, lease operations, *etc.)* plus the amount of gas it expects to deliver to its purchasers as indicated by information provided by its initial nominators pursuant to paragraph (4) of this subsection.

(B) For gas wells in fields operated under statewide rules or in fields having special spacing rules but with no gas allocation provisions (nonprorated):

(i) Form P-4, producer's certificate of compliance (on which the gatherer, the first purchaser, and the initial nominator shall be named).

(ii) Form G-10, gas well status report (semiannually in accordance with instructions on the form).

(C) For gas wells completed in associated reservoirs and operating under §3.49(b) (051.02.02.049(b)) of this title (relating to Gas-Oil Ratio) (Statewide Rule 49):

(i) Form P-4, producer's certificate of compliance (on which the gatherer, the first purchaser, and the initial nominator shall be named).

(ii) Form G-10, gas well status report (annually in accordance with instructions on the form).

(4) Subject to approval by the staff of the Oil and Gas Division, a first purchaser may request someone else to act as its initial nominator. Otherwise, the first purchaser shall act as initial nominator. The initial nominator of gas from any gas well in the State of Texas shall prepare and file monthly Form T-3, Purchaser's Nomination, in accordance with the instructions on the form. At least five days prior to the deadline for filing its Form T-3, each

initial nominator shall inform its producers of the amount it intends to nominate from each producer. Each initial nominator shall nominate for a total quantity of gas equal to the sum of the following:

(A) The quantity for which the initial nominator is the ultimate consumer. This amount will include lease shrinkage, line loss, plant fuel, compressor use, as well as the gas which the initial purchaser may consume at the point of final delivery.

(B) The total quantity of gas nominated by its downstream purchasers in accordance with the following provisions:

(i) All downstream purchasers who take more than 10 mmcf per day shall submit monthly to their initial or first nominators of gas a downstream purchaser's nomination based on a firm forecast of that purchaser's actual demand.

(ii) If a downstream purchaser takes gas from more than one source of supply, that downstream purchaser's nomination shall show expected demand from each source.

(iii) A downstream purchaser's nomination shall be based on that purchaser's purchase and sale contract obligations, system capacity requirements, customer demand, and other similarly related factors. Actual takes by a downstream purchaser shall be reasonably proportional to its nominations, although it may first satisfy its contractual minimum take obligations.

(iv) Such written monthly nominations from downstream purchasers shall be kept on file by the initial nominator for commission inspection and shall be filed with the commission on its request.

(5) The initial nominator of gas shall ratably apportion its nominations on Form T-3 and shall ratably apportion its actual take from all gas wells connected to its system so that takes from various gas producing properties shall be made without discrimination in favor of one producer or person as against another in the same field and without unjust or unreasonable discrimination as between fields. The following instructions shall apply to initial nominators in preparing nominations (Form T-3) and in taking gas from various sources of supply, and to commission staff in calculating allowables:

(A) Nominations shall be based on each well's deliverability as reflected by the well's Form G-10 on file with the commission. Actual takes shall be based on the commission's assigned allowable for each well, with proper recognition for special allowable wells and limited capacity wells.

(B) First priority in the nomination for the purchase of gas shall be given to casinghead gas and second priority to Statewide Rule 49(b) gas so that gas produced in association with oil production shall not be wastefully vented and oil production shall not be unnecessarily curtailed. Under special circumstances, if market demand factors or temporary pipeline, com-

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pressor, or other operating difficulties result in less take from a Rule 49(b) gas well than its permitted allowable, then by special commission authority such underproduction may be carried forward and balanced as would be the case for any other gas well, provided, however, that no Statewide Rule 49(b) gas well may be allowed to overproduce its permitted allowable by a cumulative total in excess of one month's allowable.

(C) No gas well of any kind shall be given an allowable in excess of its capability to produce.

(D) Each new gas well operated under §3.28 (051.02.02.028) of this title (relating to Potential of Gas Wells To Be Ascertained and Reported) (Statewide Rule 28) and §3.29 (051.02.02.029) of this title (relating to Production of Gas Limited to 25% of Potential Capacity) (Statewide Rule 29) shall be assigned an allowable not to exceed the deliverability test volume as reported on Form G-10.

(E) Actual takes from a limited capacity well in a prorated field shall not be reduced to less than its capacity to produce unless all wells in the same field with capacity to produce exceeding that of the limited capacity wells have had their actual takes ratably reduced to the level of such limited capacity well. Texas Natural Resources Code §86.091 shall control the minimum takes from gas wells.

(6) No field shall be prorated pursuant to §3.29 (051.02.02.029) of this title (relating to Nonassociated Gas Well Allowable) (Statewide Rule 29) if each well in the field has a daily deliverability of 200 mcf or less. Wells in such fields shall be assigned allowables equal to their capacity to produce.

(7) The initial nominator of gas shall maintain and submit to the commission on request the following information:

(A) The physical capacity of the system for handling gas.

(B) The total monthly market demand for gas from the system.

(C) The nominations made for each field or reservoir connected to the system (both prorated and nonprorated).

(8) On complaint of noncompliance with the provisions of this section, or alleged discrimination as prohibited by the Common-Purchaser Act, Texas Natural Resources Code §§111.081 — 111.097, such matter will be set for hearing by the commission to determine if alleged complaints of discrimination are true, and if true, the necessary action to be taken.

(9) The commission's procedure of fieldwide balancing of overproduction and underproduction shall remain effective for all gas fields, provided that should it be determined by the commission, either on complaint by an interested party or on the commission's own initiative, that fieldwide balancing is not operating properly for an individual field, the commission, after notice and hearing, shall suspend fieldwide balancing for such field and take any other appropriate action to accomplish the purpose of the allocation of

production rules.

(10) If the operation of this section causes undue hardship for any person, the commission may grant an exception after proper notice and hearing.

Authority: The provisions of this §3.91 issued under Acts 1977, 65th Leg., ch. 871, art. I, effective September 1, 1977, as amended (Natural Resources Code §§51.291 — 51.303, §§52.291 — 52.296, §§81.001 — 113.234, §§131.001 — 131.270, and §§141.001 — 141.079).

Source: The provisions of this §3.91 adopted to be effective February 5, 1978, 3 TexReg 324; amended to be effective October 5, 1978, 3 TexReg 3617; amended to be effective February 15, 1980, 5 TexReg 335.

NATURAL GAS POLICY ACT (NGPA) STATE ALTERNATE PROCEDURES

Authority: The provisions of these §§3.101 — 3.104 issued under Acts 1977, 65th Leg., ch. 871, effective September 1, 1977 (Texas Natural Resources Code §81.052), unless otherwise noted.

Source: The provisions of these §§3.101 — 3.104 adopted to be effective January 9, 1981, 5 TexReg 5048, unless otherwise noted.

§3.101 (051.02.04.001). Definitions.

The following words and terms, when used in this chapter, shall have the following meanings, unless the context clearly indicates otherwise:

Commencement of surface drilling — The spud date.

Commission and *RRC* — The Railroad Commission of Texas.

FERC — The Federal Energy Regulatory Commission.

Operator — A person acting for himself or as an agent for others and designated to the commission as the one who has primary responsibility for complying with its rules and regulations in any and all acts subject to the jurisdiction of the commission.

Other seller — A person who sells natural gas from the subject well under a contract separate from the operator's contract.

Sections 102, 103, 107, and 108 — Those sections of the Natural Gas Policy Act of 1978 (NGPA).

§3.102 (051.02.04.002). Application Procedure.

(a) An application for a category determination may be filed by the operator of a well, or, when the operator has declined to file an application, by any other seller or a working interest owner. A filing by either any other seller or a working interest owner must be accompanied by a statement that the operator

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The **Chairman**. We will now hear from panel No. 3, Mr. Stuart Mut of Atlantic Richfield Co.; Mr. C. Robert Palmer, International Association of Drilling Contractors; Mr. Dwight Moorhead, vice chairman, Petro-Lewis Corp.; Mr. William Murray, independent gas consultant; and Mr. Russell Thompson, Operational Economics, Inc.

Gentlemen, as you know, we are operating under a time constraint. Your full statements will be placed in the record.

I will ask you to limit your remarks to 5 minutes in summary of those statements.

Before starting with the first statement, Senator Domenici, did you have a question?

Senator **Domenici**. Yes, Mr. Chairman.

As I indicated to you, I hadn't been able to attend the hearings to this point. I wonder, the last panel there was a series of questions that Senator Ford asked one of the witness companies with reference to a subsidiary and affiliate proportion of the total gas that they distribute or deliver.

Do we have some general witness or some general way to summarize those kinds of facts with reference to pipelines—what portion of their gas is from affiliate or subsidiaries and then, second, what kind of average price they are paying for that kind of gas, and perhaps, third, what portion of those are take-or-pay contracts and the duration?

The **Chairman**. I think the Senator would find a good deal of that information already in the record, but to the extent that it is not and to the extent that it is available from the Department of Energy, we can request further information if he finds what we have is not adequate to his purposes.

Senator **Domenici**. I would appreciate it if we could ask our staff to try to assimilate that in a way that we could look at it.

Thank you, Mr. Chairman.

The **Chairman**. Mr. Mut.

STATEMENT OF STUART C. MUT, VICE PRESIDENT, ATLANTIC RICHFIELD CO.

Mr. **Mut**. Thank you, Mr. Chairman.

I am Stuart Mut. I am a vice president of Atlantic Richfield Co., and I am responsible for our company's domestic gas marketing.

We appreciate the opportunity to present our views on the administration's natural gas bill.

Now, we must admit that the gas industry is in a period of turmoil and adjustment. Within improved technology, we have developed deliverability in excess of demand, even though reserves have declined. Demand has declined somewhat, and prices have increased to the point where market forces are coming strongly into play.

You have heard much about fuel switching, price reductions and high-cost contracts and new contracts being negotiated at below-ceiling pricing.

Now, these market forces are beginning to be felt. There are troubles on every side. To deal with this troubled situation, the administration has presented a comprehensive plan which seeks, basically, to do two things:

First, to control the movement of consumer prices over the next few years; and, second, to orchestrate an orderly transition to a market-controlled industry.

Now, in our company, we endorse the concept of a market-controlled industry. We also recognize the necessity of dealing with consumer price concerns during the transition period; but we are also very much concerned with maintaining the momentum of the expiration and development activities needed to replace the reserves that are consumed each year.

Of the 18 points in the administration's proposal, a proposal that we feel is generally pretty well balanced, we considered two elements not to be well-designed or valid; and these to have the potential to cause seriously disruptive effects.

These two elements which have already come in for extensive discussions are, of course, the gas cap, and the PGA passthrough limitation provision.

Now, we believe that the gas cap, as presently designed, might turn out to be very low and result in substantial reduction for prices for section 102, 103, and 108 gas.

Now, if this occurs, cash flow to the producers will be cut significantly; and if you add to this the effect of the take-or-pay limitation provision, then the financial impact could be quite severe.

Now drilling for gas is already down drastically from previous levels and it should not be depressed even further.

We have two suggestions on this point. First, to eliminate renegotiated contracts from the gas cap calculation. Cap based on new contracts will be more representative of the marketplace, and will cause fewer troubles at decontrol time.

And, second, recognizing that there are great uncertainties about where the gas cap levels will land, we recommend setting side boards or limitations on both sides—on the high side, to protect consumers, and there are already provisions to that effect in the administration's bill.

And on the low side, we need a limitation to protect the integrity of the billions of dollars of investments that have already been made and to limit the reduction of funds for the gas supply activities.

We do commend this approach to the committee.

Now, as to the passthrough limitation provision. This is, indeed, a very powerful consumer protection device. Now, what it provides in essence is that no matter what happens in all the actions and interactions of the other 17 points of the administration proposal, the rate of gas price increases to the consumer will be no more than the general rate of inflation.

Now, with the consumer safety under the shield of this provision, the rest of us are presented with the task of sorting out the other pieces of the puzzle under the ground rules laid down in the bill and working toward the gas industry controlled by market forces in 1986.

Now, that surely won't be easy, but I have confidence that it can be done.

Now, here, too, there is a great deal of uncertainty into just how this passthrough limitation will work, what effects it will have on individual pipelines and the producers. We can go into the details of that a bit later.

We would summarize to say that we feel that with some modest modifications the administration bill is a workable vehicle for moving towards a market-controlled environment, For the producers, there are some bitter pills to swallow during the transition period, but if we can have decontrol in 1986, it will be worth it for the Nation.

The CHAIRMAN. Thank you, Mr. Mut.

[The prepared statement of Mr. Mut follows:]

Statement of Atlantic Richfield Company
Before the Committee on Energy and Natural Resources
United States Senate - March 12, 1983

I am Stuart C. Mut, Vice President of Atlantic Richfield Company. I am responsible for domestic natural gas marketing and purchases Company-wide. Atlantic Richfield Company is pleased to be afforded the opportunity to make this statement regarding the proposed "Natural Gas Consumer Regulatory Reform Amendments of 1983". Copies of my statement have been furnished to the Committee.

Atlantic Richfield Company is a substantial producer and marketer of natural gas. In 1982, we produced and sold to the inter and intrastate markets approximately 1300 MMCFD, and purchased or utilized for Company consumption approximately 132 MMCFD of natural gas. Over the past several years our expenditures for exploration and development have been quite substantial, and in the South 48, the emphasis has been on gas. In the 1979-1982 time period, our Company has invested about $900 million in exploratory drilling on gas prospects, another $624 million in lease bonus payments in the Gulf of Mexico, and very substantial additional sums for offshore platforms, development wells, geophysical surveys, and geological work. Thus as a major participant in the gas business, we are vitally interested in the proposed legislation.

As we consider the current situation, we must admit that the gas industry is in a period of turmoil and adjustment. Gas supply, at least in terms of deliverability, has increased to levels more than adequate to supply current demand, a welcome change from the threat of shortage that was prevalent just a few years ago. This is due in some part to advances in exploration and producing technology, and in part to the stimulus of exploration and development activity afforded by the Natural Gas Policy Act of 1978.

On the other hand, demand for natural gas has diminished somewhat due to a number of factors: the effects of energy conservation activities; the decline of industrial activity in the recession; some switching to alternate fuels; and the effects of such legislation as the Fuel Use Act and the incremental pricing feature of the NGPA. The result is that we currently have an excess of available supply over demand. We should be reminded, however, that the excess is only in our ability to deliver at demand rates. Our reserve base continues to shrink.

Meanwhile, consumer prices have increased rapidly over the past few years due to a combination of factors. It is understandable that consumers fear that gas prices might continue to escalate at an uncomfortable rate, and consequently they have a desire to limit the rate of increase. There is also a widespread belief among consumers that market forces are not operative, and that legislative action is required.

It is true that market forces have not been a significant factor in the past, as gas prices were regulated to levels substantially below the cost of alternative energy supplies. Recently, however, market forces are indeed coming in to play. An obvious example of this is that in some industrial markets burner tip prices for gas have reached or exceeded the cost of alternative fuels, and some switching to these other fuels is occurring. It is also our understanding that virtually all high cost gas contracts with "market out" clauses have been reduced in price, and that new gas sales are being negotiated at below ceiling prices, and at lesser guaranteed rates of take. The effects of these quite recent actions are beginning to show up in some recent purchase gas adjustment (PGA) hearings.

The legislation proposed by the Administration seeks to maintain a significant measure of control over the movement of consumer prices over the next several years, and concurrently to modify existing law and regulation to permit an orderly transition to a situation in which prices would be determined by market forces. As we see it, the Administration plan contains a number of initiatives that should result in progress toward these goals.

We are extremely pleased to note that Senate Bill 615 contains a date certain for decontrol (1-1-86) of wellhead prices. Another item worthy of mention is the proposal to open new market areas for offshore gas. This provision should insure that available supplies are allocated to their most beneficial use in our economic system. We are distressed at the impact that the proposed take-or-pay limitation (more properly take-or-prepay) will have on our Company and other producers, but recognize the practical necessity for some such action in the present situation.

Atlantic Richfield Company heartily endorses the concept that gas prices should be responsive to, and in fact, determined by market forces. We also recognize the practical necessity of providing assurance to the consumer that gas prices will not escalate at unreasonable rates. In moving toward these objectives, however, we should also take care not to inhibit the ability of the exploration and production components of this industry to find and develop the new reserves necessary to maintain this important element of the nation's energy economy.

The Administration bill is a reasoned effort to provide a balanced solution to a complex set of problems. As mentioned earlier in these hearings, balance is a key element in constructing a viable bill.

On this point I would like to discuss two elements of the bill which in our view are not well balanced, and which have the potential to cause seriously disruptive effects. We suggest that these provisions be modified and improved without altering the basic concepts. These two elements are:

1) the contemplated roll-back of legislatively authorized contract prices to an indefinite gas cap level, and

2) the establishment, in practical effect, of a ceiling on all new gas purchases for the interstate market at the level of each pipeline's weighted average cost of purchased gas plus an inflation adjustment, the so-called pass-through limitation provision.

The Gas Cap Provision

The proposed gas cap price would be established as the volume weighted price of natural gas sold under contracts executed or amended after the enactment of this Bill. The Administration's section by section analysis states "This provision would permit natural gas prices to be established immediately in accordance with market forces and not the existing artificial price ceilings". We do not agree with this assessment.

Renegotiated contracts covering low price gas would not likely be escalated to a level approaching free market prices, and in fact might be quite low relative to so-called market clearing prices.

On the other hand an argument can be made that new gas contracts will come closer to reflecting market forces, but even these would be influenced by the PGA pass-through limitation. Considering the current "oversupply" in the gas market, new gas will be sold into a buyer's market at moderate prices and modest guaranteed volumes. (Some pipelines have virtually stopped acquiring new supplies at all.)

Given this situation, it is possible that the gas cap would be set at levels substantially below the current price levels for alternative fuels, and would result in substantial rollbacks of prices now being received for flowing gas in the NGPA categories 102, 103, and 108. It is difficult to accept as appropriate or fair the notion of rolling back prices legislatively determined to be just and reasonable less than five years ago. Recall that these prices did, in fact, induce the successful exploration and development of badly needed new gas supply and brought an end to the shortages experienced in the mid-70's. While some of these prices may now be perceived to be in excess of market levels, it should be remembered that investment decisions and loan obligations amounting to billions of dollars were made in the expectation and belief that governmentally stipulated prices would not be arbitrarily reduced. A price roll-back in such circumstances is an extremely drastic action.

It is quite understandable that consumers, after enjoying the benefits of artifically-set low prices for gas for many years, are disturbed at the price increases of recent years which have brought gas prices, on average, closer to the cost of alternative fuels.

But all of us, producers, pipelines and consumers alike, should be concerned about the effect of a price roll-back on the ability of the producing industry to fund a continuing exploration and development effort sufficient to maintain adequate supplies. We have seen the estimates made by the Department of Energy as to how much consumer prices might be lowered under the Administration proposal. The range cited is 10 to 30 cents per MCF. Assuming this range is a realistic estimate, it is apparent that most of the impact of the roll-back will fall on gas supplies brought into the market since the NGPA was enacted, specifically Section 102 and 103 gas. Nationwide, these categories now supply approximately one-third of domestic production. Thus in order to achieve a 10 to 30 cent reduction in consumer prices, the roll-back of wellhead prices for Sec. 102 gas would approximate 30 to 90 cents per MCF, and up to 30 cents per MCF for Sec. 103 gas.

If this occurs the reduction of internally generated cash flow in producer companies will be substantial. When this is coupled with the proposed reduction in take-or-pay obligation contemplated by the act, the money avails to support exploration and development activities will be seriously diminished. Drilling activity in this country has already declined by nearly 50% from the peak reached at year-end 1981 and drilling for gas, particularly in the independent sector, appears to have decreased by an even greater percentage. If we adopt additional measures which would have the effect of decreasing gas drilling even further, it is easily predictable that we will soon be back into a condition of shortage and curtailment, and all the problems that would bring.

Nevertheless, assuming that a gas cap feature which could require some measure of price roll-back is perceived as an essential element of consumer protection in a transition period, it would seem desirable, in order to avoid distortions that would prove troublesome at the end of the control period, that the gas cap level provide a reasonably close approximation to a free market price. Though an imperfect measure, this might be done by setting the cap at the volume weighted average of only the new gas contract prices.

It is our belief that if this change to the Administration proposal is made, some degree of roll-back of current prices will occur, but not of such magnitude as to cause unmanageable problems.

Regardless of the design of the gas cap, there is significant uncertainty as to the resulting gas cap price level. Consumer groups fear it will be very high, producer groups fear that it might be very low. Since either of these results is not to be desired, we offer the suggestion that sideboards be adopted which would limit the effect of variations in the gas cap level in either direction. A high-side limit is already proposed in the Administration bill. Another high-side limitation is indirectly imposed by the workings of the pass-through limitation provision. A low-side limit would operate to protect the integrity of existing investments, and to preserve the source of funding required for ongoing producing activities.

We commend this approach to the Committee's consideration.

The Pass-Through Limitation Provision

Secretary Hodel has described the pass-through limitation provision as the linchpin of the Administration plan. Indeed it is a very powerful consumer protection device. What it provides in essence is that no matter what happens in all the actions and interactions of the other 17 points of the Administration proposal, the rate of gas price increases to the consumer will be no more than the general rate of inflation. With the consumer safely under the shield of this provision, the producers, pipeliners, and distributors are presented with the task of sorting out the other pieces of the puzzle under the ground rules laid down in the bill, and working towards a gas industry controlled by market forces in 1986.

While the consumer protection aspect of the pass-through limitation is straightforward, there is a great deal of uncertainty in just how it will work and what effects it will have on individual pipelines and the producing industry. As structured, it will adversely impact the ability of some pipelines as compared to others to acquire new supply, regardless of need. One can also postulate conditions under which it may also operate to limit the total market demand for new gas supply and thus inhibit necessary exploratory and development efforts. We are certain that the pipelines will be offering detailed suggestions and comments from their point of view.

As a producer, we can see a reduction in the number of potential pipeline purchasers permitted to pay reasonable prices for new supply, and this could have the effect of reducing exploratory effort.

This linchpin provision is indeed worthy of careful consideration before its design is finalized. We are not prepared at this point to suggest a balanced solution but will continue our studies and hope to have an opportunity to comment at a later date.

In summary, we feel that with some modest modifications the Administration bill is a workable vehicle for moving towards a market-controlled environment. For the producers there are some bitter pills to swallow during the transition period, but if regulatory control over the gas producing industry can be eliminated in 1986 as proposed, we feel that the nation as a whole will be well served.

The CHAIRMAN. Mr. Palmer.

STATEMENT OF C. R. PALMER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ROWAN COMPANIES, INC., ON BEHALF OF THE INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

Mr. PALMER. Mr. Chairman.

I am Bob Palmer, chairman of Rowan Companies, Houston, Tex. Rowan is entering its 60th year as a contract drilling firm. We also operate a fleet of helicoptors and aircraft in Alaska, and we invest in a very minor way in oil and gas exploration.

Thirty years ago, when I was a freshman engineering student, I started to work for Rowan as a roughneck. About that same time, the Federal Government and Phillips Petroleum Co. were debating the proposed price controls on natural gas; and, of course, as a result of that debate, we have added a footnote to the Declaration of Independence, in which we now state that, among our "unalienable rights" are "life, liberty, and the pursuit of cheap gas."

I think that we also should note that in the world today that approximately 85 percent of our population is heating or cooking on some fuel other than petroleum.

But I am here today as 1983 chairman of the executive commitee and the past president of the International Association of Drilling Contractors.

IADC is a trade association representing oil and gas drilling contractors throughout the world. Our total membership is about 1,000. Ninety-five percent are United States-based.

I think that it should be noted for the record that we operate in 34 states in the United States, not just Texas, Louisiana, and Oklahoma.

And I trust that each of you will recognize as the essential role which drilling contractors play in the overall petroleum industry. Contrary to the popular notion, very few petroleum exploration and production companies actually own their own rigs.

With few exceptions, the drilling is done by the drilling contractors. The contractor supplies not only the rigs but the manpower and much of the technology.

The drilling contractors' role is vital to the exploration efforts of the oil and gas producing companies.

I have which I would like to leave with you an issue that has just been presented by the Petroleum Engineering Magazine. It has about 45 pages. It describes 1982 drilling results, in which 1,205 wells were drilled at a depth below 15,000 feet in 17 States, at a cost of $8 billion.

One hundred and eighty-three drilling contractors participated in that, drilling wells for 242 operators. Two-thirds of those wells were dry.

I appear before you today to voice grave concerns of IADC members about one possible result of the proposed Natural Gas Consumer Regulatory Reform Amendments of 1983.

As we understand the proposed legislation, we believe there will be little near term incentive to search for new discoveries of so-called deep gas.

If the price received by gas producing companies and gas transmission companies is less than the finding cost of new reserves, exploration will virtually cease.

Without new wells, the current gas surplus will become a gas shortage, and the only workable method of allocating that scarcity will be through increased price, to the detriment of the consumer you wish to protect.

As Earl Butz, the ex-Secretary of Agriculture, so aptly put it, when he was arguing for the deregulation of beef prices, "I can never understand the mentality of anyone who thinks he can have more by paying less."

IADC asks this committee to carefully examine the Nation's long-term interest as well as the consumers' demand to have more by paying less. If deep gas reserves and continued exploration are vital to the economic health and security of this Nation, then we suggest that the proposed legislation should be clear: Purchasers can pay whatever they must to acquire new supplies of deep gas to ensure that the consumers' demands are met, and these costs can be recovered at the burner tip.

The IADC supports the early decontrol of all natural gas without an excise tax and the repeal of end use control. We do not address any portions of the bill which deal with production from existing wells. That is being more than adequately dealt with many other companies and organizations.

I am concerned only with what I see as possible limitations on new well drilling and the corresponding economic impact on the contract drilling industry.

Please note that I am not complaining about what the free market for deep gas has already done. We have a lot of stacked rigs, and we have had some spectacular bankruptcies, but this is the discipline of freer market economics.

Free market economics and pure competition are a drilling contractor's "oversight committee." There are 1,000 contractors operating over 5,000 rigs and no single contractor has over 3 percent of the market.

We have complete freedom of entry—and exit.

The primary prerequisite for being a drilling contractor are being naive enough to believe your customers forecast of market demand, and to be brave enough to use your entire line of credit on speculative investment, and the ability to forget all of the industry abrogations in the last 60 years.

The CHAIRMAN. Mr. Palmer, thank you very much for your testimony. I am sorry to have to interrupt, but your statement will be included in the record.

[The prepared statement of Mr. Palmer follows:]

STATEMENT OF C. R. PALMER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ROWAN COMPANIES, INC., HOUSTON, TEX., ON BEHALF OF THE INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

MR. CHAIRMAN, I AM C. R. PALMER, CEO OF ROWAN COMPANIES, HOUSTON, TEXAS. ROWAN IS ENTERING ITS 60TH YEAR AS A CONTRACT DRILLING FIRM. WE ALSO OPERATE A FLEET OF HELICOPTERS AND FIXED WING AIRCRAFT PRINCIPALLY IN ALASKA AND WE INVEST IN A VERY MINOR WAY IN OIL AND GAS EXPLORATION.

THIRTY YEARS AGO, AS A FRESHMAN ENGINEERING STUDENT, I STARTED TO WORK FOR ROWAN AS A ROUGHNECK. ABOUT THIS SAME TIME, THE FEDERAL GOVERNMENT AND PHILLIPS PETROLEUM WERE DEBATING PROPOSED PRICE CONTROLS ON NATURAL GAS.

I AM HERE TODAY AS 1983 CHAIRMAN OF THE EXECUTIVE COMMITTEE AND A PAST PRESIDENT OF THE INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS (IADC). IADC IS A TRADE ASSOCIATION REPRESENTING THE OIL AND GAS WELL DRILLING CONTRACTORS. OUR TOTAL MEMBERSHIP NUMBERS ALMOST 1,000 CONTRACTORS WORLDWIDE, ABOUT 95% OF WHOM ARE U.S. BASED.

I TRUST THAT EACH OF YOU RECOGNIZE THE ESSENTIAL ROLE WHICH DRILLING CONTRACTORS PLAY IN THE OVERALL PETROLEUM INDUSTRY. CONTRARY TO POPULAR NOTION, VERY FEW PETROLEUM EXPLORATION AND PRODUCTION COMPANIES ACTUALLY OWN DRILLING RIGS. WITH FEW EXCEPTIONS, EXPLORATION AND PRODUCTION DRILLING IS DONE BY DRILLING CONTRACTORS. THE CONTRACTOR SUPPLIES NOT ONLY THE RIGS, HE ALSO SUPPLIES THE MANPOWER, AND MUCH OF THE DRILLING TECHNOLOGY. THE DRILLING CONTRACTORS ROLE IS VITAL TO THE EXPLORATION EFFORTS OF THE OIL AND GAS PRODUCING COMPANIES.

I APPEAR BEFORE YOU TODAY TO VOICE THE GRAVE CONCERNS OF IADC

MEMBERS ABOUT ONE POSSIBLE RESULT OF THE PROPOSED "NATURAL GAS CONSUMBER REGULATORY REFORM AMENDMENTS OF 1983." AS WE UNDERSTAND THE PROPOSED LEGISLATION, WE BELIEVE THERE WILL BE LITTLE NEAR TERM INCENTIVE TO SEARCH FOR NEW DISCOVERIES OF SO-CALLED DEEP GAS. IF THE PRICE RECEIVED BY GAS PRODUCING COMPANIES AND GAS TRANSMISSION COMPANIES IS LESS THAN THE FINDING COST OF NEW RESERVES, EXPLORATION WILL VIRTUALLY CEASE. WITHOUT NEW WELLS, THE CURRENT GAS SURPLUS WILL BECOME A GAS SHORTAGE AND THE ONLY WORKABLE METHOD OF ALLOCATING SCARCITY IS THROUGH INCREASED PRICE -- TO THE DETRIMENT OF THE CONSUMER WHOM YOU MAY WISH TO PROTECT.

AS EARL BUTZ, THE EX-SECRETARY OF AGRICULTURE, SO APTLY PUT IT, WHILE ARGUING FOR DEREGULATION OF BEEF PRICES, "I CAN NEVER UNDERSTAND THE MENTALITY OF ANYONE WHO THINKS HE CAN HAVE MORE BY PAYING LESS".

I BELIEVE THAT YOU WILL FIND A CONSENSUS BOTH INSIDE AND OUTSIDE THE INDUSTRY THAT DEEP GAS IS OUR BEST LONG-TERM HOPE FOR A CLEAN, RELIABLE AND RELATIVELY INEXPENSIVE ENERGY SOURCE. SHOULD GOVERNMENT ACTION REMOVE THE INCENTIVE TO EXPLORE FOR DEEP GAS, NONE WILL BE FOUND AND A SHORTAGE OF GAS WILL RESULT -- WHETHER OR NOT DEMAND INCREASES -- SIMPLY FROM THE DECLINE OF EXISTING RESERVOIRS. SUDDENLY, ON A SINGLE DAY, OUR SURPLUS GAS PROBLEM WILL BECOME A GAS SHORTAGE AND WHEN THAT DAY ARRIVES -- LIKE IT OR NOT -- WE WILL BE COMPELLED ONCE AGAIN TO SEEK AND FIND VERY LARGE DEEP RESERVES. ON THAT DAY, WE WON'T HAVE TIME FOR THE KIND OF BUILD-UP THAT WAS REQUIRED TO BRING OUR DEEP DRILLING CAPACITY TO ITS PRESENT STATE THAT OCCURRED

AFTER PASSAGE OF THE NATURAL GAS POLICY ACT OF 1978.

THE IADC ASKS THAT THIS COMMITTEE CAREFULLY EXAMINE THE NATION'S LONG TERM INTERESTS AS WELL AS THE CONSUMERS DEMAND TO "HAVE MORE BY PAYING LESS". IF DEEP GAS RESERVES AND CONTINUED EXPLORATION ARE VITAL TO THE ECONOMIC HEALTH AND SECURITY OF THIS NATION, THEN WE SUGGEST THE PROPOSED LEGISLATION SHOULD BE CLEAR THAT PURCHASERS CAN PAY WHATEVER THEY MUST TO ACQUIRE NEW SUPPLIES OF DEEP GAS TO ENSURE THAT THE CONSUMERS' DEMANDS ARE MET AND THESE COSTS CAN BE RECOVERED AT THE BURNER TIP.

THE IADC SUPPORTS THE EARLY DECONTROL OF ALL NATURAL GAS WITHOUT AN EXCISE TAX AND THE REPEAL OF END USE CONTROLS. THIS STATEMENT WILL NOT ADDRESS ANY PORTIONS OF THE BILL WHICH DEAL WITH PRODUCTION FROM EXISTING WELLS. THAT IS BEING DEALT WITH BY MANY OTHER COMPANIES AND ORGANIZATIONS. I AM CONCERNED ONLY WITH WHAT I SEE AS POSSIBLE LIMITATIONS ON NEW WELL DRILLING AND THE CORRESPONDING ECONOMIC IMPACT ON THE CONTRACT DRILLING INDUSTRY.

AT THE LAST INDUSTRY CENSUS IN AUGUST 1982, THERE WERE 1,717 RIGS IN THIS COUNTRY CAPABLE OF DRILLING TO 16,000 FEET OR DEEPER (SEE TABLE 1). THIS NUMBER COMPARES TO THE 693 EXISTING WHEN NGPA WAS PASSED IN 1978. EACH OF THOSE RIGS REPRESENTS AN INVESTMENT IN THE RAGE OF $4-8 MILLION. IN 4 YEARS, THEN, WITH NO SUBSIDIES, OR LOAN GUARANTEES OR SAFETY NETS, DRILLING CONTRACTORS INVESTED OVER $5 BILLION FOR DRILLING RIGS TO EXPLORE FOR DEEP GAS. THIS SUM DOES NOT INCLUDE ADDITIONAL BILLIONS INVESTED BY OTHER OIL

SERVICE COMPANIES SERVING THE DEEP-GAS MARKET.

THIS UNPRECEDENTED GROWTH OF OUR INDUSTRY WAS DUE TO ONE THING AND ONE THING ONLY: THE BELIEF THAT VERY LARGE GAS RESERVES COULD BE FOUND AND THAT ONCE FOUND, THE GAS COULD BE SOLD FOR MORE THAN IT COST -- (INCLUDING THE COST OF A LOT OF DRY HOLES THAT IN MANY CASES EXCEEDED $15.0 MILLION EACH). AND WHAT CAUSED THIS BELIEF; THE NATURAL GAS POLICY ACT OF 1978 WHICH DEREGULATED GAS DISCOVERED BELOW 15,000 FEET.

I ASSUME THAT BACK IN 1978, CONGRESS DECIDED FOR A NUMBER OF PUBLIC POLICY REASONS THAT AN INCREASE IN THE DOMESTIC GAS RESERVES WAS OF SUFFICIENT IMPORTANCE TO DEREGULATE ALL GAS FOUND BELOW 15,000 FT. THUS, A PRODUCER COULD CHARGE WHATEVER PRICE A CUSTOMER WOULD PAY. AND YOU CAN ONLY BE IMPRESSED AT HOW SUCCESSFUL THE EFFORT WAS. ENOUGH DEEP GAS WAS DISCOVERED TO BRING THE PRICE ON NEW CONTRACTS DOWN FROM A HIGH OF $9 OR $10/MCF TO THE PRESENT RATES OF $5/MCF AND LESS -- A TANGIBLE EXAMPLE OF THE FREE MARKET SYSTEM IS AT WORK

WHAT WILL THOSE 1,717 DEEP RIGS DO IF THIS LEGISLATION CAUSES DEEP GAS EXPLORATION TO CEASE? WITH ALL TOO FEW EXCEPTIONS, THEY WILL SIMPLY BE STACKED IN SOME GOAT PASTURE TO DETERIORATE AND RUST. THEIR OWNERS WILL, IN MANY CASES, GO BANKRUPT.

PLEASE NOTE: I AM NOT COMPLAINING ABOUT WHAT THE FREE MARKET IN DEEP GAS HAS ALREADY DONE. WE ALREADY HAVE A LOT OF STACKED RIGS. WE ALREADY HAVE HAD SOME SPECTACULAR BANKRUPTCIES. THIS IS THE

DISCIPLINE OF FREE MARKET ECONOMICS.

FREE MARKET ECONOMICS AND PURE COMPETITION ARE A DRILLING CONTRACTOR'S "OVERSIGHT COMMITTEE". THERE ARE 1,000 CONTRACTORS OPERATING OVER 5,000 RIGS AND NO SINGLE CONTRACTOR HAS OVER 3% OF THE MARKET. THERE IS COMPLETE FREEDOM OF ENTRY -- AND EXIT. THE PRIMARY PRE-REQUISITES ARE NAIVETE, BRAVERY AND AMNESIA. ONE MUST BE NAIVE ENOUGH TO BELIEVE THE MARKET DEMAND INFORMATION PROVIDED BY CUSTOMERS; BRAVE ENOUGH TO USE AN ENTIRE LINE OF CREDIT ON SPECULATIVE INVESTMENTS -- THAT ARE MADE MORE ON FAITH THAN FACT; ADD TO THESE AN ABILITY TO FORGET THE INDUSTRY ABERRATIONS IN A 60 YEAR HISTORY IN THE CONTRACT DRILLING BUSINESS.

WE ARE CONCERNED THAT THE END PRODUCT OF THIS LEGISLATION WILL BE ONE THAT ASSURES THE RIGS WILL NOT GO BACK TO WORK UNTIL SOME ARBITRARY FUTURE DATE WHICH CAN EASILY BE POSTPONED AND REPOSTPONED BY FUTURE GOVERNMENT ACTION. AND, MAKE NO MISTAKE, LIMITING DEEP GAS TO SOME ARBITRARY PRICE CAP OR LIMITING A TRANSMISSION COMPANY'S ABILITY TO PASS THROUGH HIS COSTS WILL ACHIEVE THE SAME RESULT AS AN ABSOLUTE PROHIBITION AGAINST DRILLING. ALMOST 30 YEARS AGO THAT FACT WAS CLEARLY PROVEN -- WHEN PHILLIPS LOST THE FIRST GAS PRICE DEBATE -- BUT IN SPITE OF THIS HISTORY, THE DEBATE GOES ON.

THOSE UNFAMILIAR WITH THE INDUSTRY AND WITH DRILLING EQUIPMENT WOULD ASK WHY WE DO NOT SWITCH FROM GAS DRILLING TO OIL DRILLING -- OR SIMPLY ADAPT TO SHALLOWER DEPTHS. THE ANSWER IS TWO-FOLD. FIRST, THE DEEPER FORMATIONS FAVOR THE ACCUMULATION OF GAS, RATHER THAN OIL;

THERE AREN'T MANY DEEP OILWELLS TO DRILL. SECOND, THE DEEPHOLE RIG IS A SPECIAL PURPOSE BUILT MACHINE WHICH CANNOT COMPETE AT SHALLOWER DEPTHS ANYMORE THAN AN 18-WHEEL TRUCK CAN COMPETE IN THE PICK-UP TRUCK MARKET.

DRILLING CONTRACTORS BUILT A DEEP DRILLING CAPABILITY BASED ON THE NGPA PROMISE OF A FREE MARKET FOR DEEP GAS. THAT MARKET IS THE ONLY ONE OUR INDUSTRY SEGMENT HAS THE CAPABILITY TO SERVE. WE SEE NO LOGICAL REASON WHY CONTRACT DRILLERS AND OUR CUSTOMERS WHO EXPLORE FOR DEEP GAS SHOULD BE LEGISLATED TO FINANCIAL RUIN BECAUSE OF OUR OVER ACHIEVING THAT WHICH CONGRESS MANDATED.

BUT IF FINANCIAL RUIN FOR A SEGMENT OF OUR INDUSTRY IS A PRICE THAT MUST BE PAID FOR DEREGULATION OF NATURAL GAS, THEN I SUPPOSE THE IADC WILL ACCEPT IT. AT LEAST, I DON'T THINK YOU WILL SEE THIS ASSOCIATION COMING UP HERE LOOKING FOR A BAILOUT, A HANDOUT, OR GOVERNMENT GUARANTEED LOANS.

WE THANK YOU FOR THE OPPORTUNITY TO PRESENT OUR VIEW AND WOULD BE PLEASED TO ANSWER ANY QUESTIONS YOU MAY HAVE.

TABLE 1

U. S. FLEET OF DOMESTIC RIGS CAPABLE OF DRILLING TO 16,000 FEET OR BELOW

YEAR	NUMBER OF RIGS
1975	448
1976	498
1977	577
1978	693
1979	872
1980	1,059
1981	1,405
1982	1,717

SOURCE: REED ROCK BIT COMPANY ANNUAL CENSUS OF AVAILABLE RIGS, TAKEN ANNUALLY IN AUGUST.

The CHAIRMAN. Mr. Moorhead.

STATEMENT OF DWIGHT MOORHEAD, VICE CHAIRMAN OF THE BOARD, PETRO-LEWIS CORP.

Mr. MOORHEAD. Thank you, Mr. Chairman.

I am Dwight Moorhead, vice chairman of Petro-Lewis Corp., based in Denver, and we very much appreciate the opportunity of presenting testimony today.

As an independent producer, Petro-Lewis operates over 5,000 producing oil and gas properties in 23 States, and holds interests in several thousand additional properties operating by the companies.

Daily production net to the Petro-Lewis interests now approximates 48,000 barrels of oil per day, and 206 million cubic feet of gas a day under 3,000 gas contracts representing contracts with nearly every sizable interstate and intrastate purchaser.

The Petro-Lewis interests I referred to include our corporate account and the accounts of about 140,000 limited partners from every one of the 50 States.

By many standards Petro-Lewis is a fast-growing production company, and continues to be among the fastest growing in the United States, and I speak from our position as a producer of gas.

I trust that the written testimony that we have submitted will be included in the record.

Let me make a few further comments.

We unqualifiedly support the passage of the administration's Natural Gas Policy Act reform bill for the following reasons:

It decontrols all gas by a date certain. It permits renegotiation of contracts which will bring sensitivity to supply/demand factors into a presently rigid market structure.

It promotes the creation of a national market to replace present regional, local, scope of markets, and smooths the transition for free competitive markets for all parties.

It is fairly balanced, we believe, and it is well timed. It is likely to reduce the cost of gas to consumers in the short run, but is the only way—free markets, that is, are the only way to insure the consumer the benefits of the availability of gas at the best possible cost in the long term.

It requires the sheltered, often noncompetitive participants and the production, transportation, and distribution chain to become intensely active and responsive to marketplace, because the transition holds the potential of some gains and for severe losses to each of the participants in this industry.

We, for example, expect to become intensely active in marketing efforts if this bill becomes law.

The uncertainty of the transition is frightening, but generally producers are market-risk tolerant, as they are regulatory-risk intolerant.

Let me make several observations, and then look forward to your questions.

This bill is complex, but it is complex only in its transitional aspect of the simplicity of a free market. It is not clear to me that producers and users will have adequate access to pipelines to affect most of the possible market transactions, especially the short-term spot market transactions that are so necessary for a true, free market.

The inclusion of renegotiated contract prices and the gas cap is a real impediment to free negotiation of lower price contracts by its depressing effects on the prices that may result in retarding drilling—ongoing drilling activity.

We have a simple concern—to achieve decontrol, to achieve truly free open market. We have to be concerned in that respect in order to achieve it with a transition and with the mechanics of achieving.

That means that it is critical to decontrol, to have an effective, a politically and economically acceptable transition method, and then the mechanics involved in the elimination of fuel use and incremental pricing provisions to get real access to the transportation system, to have the opportunity, the requirement to renegotiate; and the final point, producers today are desperate for cash flow. They are not hung up on price per MCF, but they must have markets.

With the return of markets and they settle regulatory environment, producers will begin to drill again.

I think that you probably have had testimony to the contrary, but I think that we, for example, would be drilling, would be participating in drilling of several hundred wells this year, to develop moderate depth, moderate cost gas, if we had assurance of a market, if we were certain of our regulatory climate.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Moorhead follows:]

TESTIMONY BEFORE SENATE ENERGY COMMITTEE

BY

DWIGHT MOORHEAD, VICE CHAIRMAN OF BOARD

PETRO-LEWIS CORPORATION

MARCH 12, 1983

INTRODUCTION

Mr. Chairman, my name is Dwight Moorhead, and I'm Vice Chairman of the Board of Petro-Lewis Corporation, an independent producer of oil and gas that has been headquartered in Denver, Colorado, since its inception in 1968. The company and its 140,000 limited partners own and operate hydrocarbon-producing properties located throughout the United States. Petro-Lewis has five regional offices in Houston (Texas), Oklahoma City (Oklahoma), Billings (Montana), Lubbock (Texas) and Bakersfield (California), and the majority of our 2100 employees work out of these regional offices. At the present time, Petro-Lewis produces 48,000 barrels per day of oil and 206 million cubic feet/day of gas. The company has entered into more than 3,000 contracts for the sale of these hydrocarbons. Fifty percent of our hydrocarbon production is from oil, and fifty percent is from natural gas. Of our gas production, 60% is from the "older" Natural Gas Policy Act categories (Secs. 104, 106, 108) and 40% comes from the "newer" categories (Secs. 102, 103, 107, 109). About 6% comes from Sec. 107 natural gas. This gas distribution is very much like the national average. Table 1 in the Appendix details the distribution of natural gas by each of our major partnerships.

PETRO-LEWIS SUPPORTS HODEL'S NATURAL GAS POLICY ACT REFORM BILL

Petro-Lewis corporation supports Secretary of Energy Hodel's Natural Gas Policy Act Reform Bill because it ultimately decontrols all wellhead prices, permits renegotiation of contracts in order to inject greater sensitivity to the market forces of supply and demand, gets the nation over the uncertainties inherent in decontrol of natural gas prices, improves and enlarges the marketing system for natural gas in this country, and smooths the transition path to decontrol during 1983-85 for all parties.

The company can appreciate the problems of consumers in dealing with retail natural gas costs. We feel that federal energy policy should be appropriately addressing the problems in the Natural Gas Policy Act (NGPA78), which largely account for the rapid increases in retail prices paid by consumers of natural gas in recent years. The Natural Gas Policy Act created a system of controls and regulations which produced some uneconomic and unforeseen results. The experience of the U.S. in regulating natural gas markets over the last 3-4 decades demonstrates just how difficult it is to establish an equitable system that charges customers reasonable rates while providing producers with enough incentives and profits to be able to drill for future supplies, and, at the same time, insuring pipelines steady and high load factors so that pipeline rates are reasonable for all. Petrol-Lewis believes that markets unencumbered by complex regulations have the best chance of balancing the interests of all - consumers, producers, pipelines, and the national energy security both now and in the future.

The Company agrees with the Administration and Congress that now is an excellent time to decontrol all gas prices, to permit renegotiation of contracts, and to allow industry and utilities greater access to the natural gas market. Demand for natural gas is weak, largely due to the effects of recession. Natural gas has lost part of its share of U.S. energy demand, and the domestic production is less than last year's. This loss of market share is largely due to the recession, and this situation can be expected to improve in the next few years with economic recovery. But another portion of that loss has to do with fuel-switching, either to residual fuel oil or to coal or nuclear fuels by industrial and utility customers. The switch to coal or nuclear fuels is probably a permanent loss to natural gas supplies because of the investment in such energy systems. The switch to residual fuel might be considered a more temporary loss, largely determined by the relative prices of gas versus #6 or #2 oil. The Powerplant and Industrial Fuel Use Act also mandated a large part of the permanent and temporary fuel-switching away from gas. It has been estimated that since passage of the Natural Gas Policy Act, more than 40% of industrial firms have added the ability to burn other fuels on short notice. Industrial firms' uncertainty on price and availability of natural gas supplies has increased since 1978. Today, domestic gas supplies are relatively abundant, as are imported supplies. Crude oil prices are likely to be stable in the next few years as OPEC's marginal capability to produce far outstrips world demand. Petroleum product prices for residual fuel oil, with which natural gas fiercely competes in industry, are therefore likely to be stable or only slowly increasing. We believe that natural gas prices would probably decline in decontrolled markets during 1983, and if economic recovery continues, natural gas should regain a significant part of the temporary load loss experienced in 1981-82 to residual fuel oil.

If Congress should decide to retain the Natural Gas Policy Act as is and without reform, we do not expect any significant price "flyup" problem in 1985, because we believe the market clearing price for gas to be in the $3.75-4.50/mcf price range. However, significant volumes of gas, (about 45-50%), i.e., old gas, would remain under price controls. The gas market would be artificially split into two parts, creating uneconomic distortions. For example, this presence of old, price-controlled gas would not help to keep retail consumer gas prices down - witness the dismal failure of old gas and the "gas cushion" to do so under the Natural Gas Policy Act today. Producers drilled more gas wells in older fields after 1979 that qualify for new prices, and they drilled deeper or offshore and received higher prices. As old gas has been depleted, new supplies have been added from much more expensive sources, including imports.

However, it was not the Natural Gas Policy Act with its provisions for a free market price for Sec. 107 gas that was solely responsible for the sharp upturn in drilling activity. Rather, it was the combination of market price and the extreme shortage of deliverability that had been experienced in 1978-79, which caused the pipelines to purchase gas under contracts with quite favorable "take" provisions from producers, sometimes providing for 100% of deliverability from high-cost wells. Deliverability refers to the optimum amount of daily production that a well is capable of, without damage.

At the present time, these contracts may seem imprudent, but it is this newer, more expensive source of supply that is the principal reason why we have not had recurring shortages of deliverability during periods of peak demand. Petro-Lewis believes that without these high-cost, marginal supplies, we could even now be experiencing shortages of deliverability. Therefore, while the provisions of the Natural Gas Policy Act did encourage drilling and an overall improvement in the level of reserves, it was specifically the Sec. 107

provisions which offered the opportunity to bring these marginal supplies to market and, thus, furnish the nation with the current, good deliverability situation.

Recontrol in its many varieties is a negative reaction to current problems in the natural gas market. It wishes the problem away, rather than reforming the Natural Gas Policy Act. Temporarily, consumers might be pleased, but would they be happy when shortages of gas deliverability occur in 1985 for industrial uses and utility uses, leaving them jobless and cold? The current excess of gas deliverability will be worked off in 2-3 years according to a recent Merrill Lynch study, if the economic recovery remains on track. Also, the development of future gas supplies would be ignored if gas prices were frozen for any length of time.

Therefore, Petro-Lewis is testifying today in support of Secretary Hodel's Natural Gas Policy Act Reform bill. We would also like to explain to Congress how the Reform bill's technical aspects will affect Petro-Lewis as an independent producer, owning a well diversified group of properties. But before I begin, I would like to discuss our view of how the natural gas market works and the problems which surfaced with the Natural Gas Policy Act.

GENERAL CHARACTERISTICS OF THE NATURAL GAS MARKET

The natural gas market has a few key characteristics which should be kept in mind throughout your deliberations.

(1) It is segmented, i.e., there are many competitive wellhead producers, regulated by Natural Gas Policy Act and governed by long-term contractual relationships, largely with pipelines. Pipelines sell gas to each other, to local distributors, and to large industrial or utility customers. They are governed as utilities by FERC, state utility commissions, and by their long-term contracts with customers. There are very few pipelines in any given region so that they can exercise monopsonist powers over gas producers, limited only by their utility mandate to serve their own customers (other pipelines or large gas buyers). There are large gas buyers, utilities, and industrial firms, which can establish contractual relations with pipelines (most cases) or directly with gas producers, but usually do so only in their region. The large buyers have monopsonist powers, versus producers, depending on the amount of heavy industry using gas in the region. (2) Natural gas is a depleting resource. As we use it up, the easy-to-find and cheap sources of supply disappear, and we are left with higher cost and harder-to-find reserves. That fundamental fact of life implies price increases over time. During the 1960's, a period where the producer price index in the U.S. actually declined, and there was only a slight increase in consumer prices, the Joint Association Survey of Independent Petroleum Producers showed a constantly declining productivity of drilling. Over that decade, it took an increasing dollar expenditure

to find each million Btu's of new reserves. (3) Natural gas is only transported by pipeline, and it cannot be stored easily or cheaply. Therefore, the U.S. market is geographically regionalized. Purchasers must build systems to receive gas and finance, as well as amortize, the cost of that investment. (4) The contracts established in the natural gas industry encompass legitimate business needs. "Take-or-pay" provisions assure producers of a reasonable cash flow when demands for gas are low and protect producers from drainage losses in the gas fields. Normally, pipelines can temporarily offset lower current "takes" for larger future "takes". "Take-or-pay" clauses also assure prudent contracting practices by pipelines. Because pipelines are utilities, and not common carriers, they use "take-or-pays" to line up future reserves to meet their customer service requirement over time. Contracts can include natural gas reserves not yet drilled by producing companies, and can also provide incentives for producers to carry out such drilling. So contracts encompass both price, current supplies and potential future supplies of gas. Price escalator clauses reflect the depleting nature of the resource and the long term of the contract, thus protecting the producer's investment in wells and field development.

The cost of gas to a pipeline includes several components, and these include the following, from high cost to low cost:

1. Imported gas, including liquefied natural gas
2. Purchases from other pipeline companies
3. The pipeline's own production
4. The average cost of total wellhead purchases by the pipeline.

The average cost of purchased gas, in turn, has a number of components in descending order of importance, including:

1. Decontrolled gas
2. Gas from tight sands which have received approval of higher prices from FERC and other Sec. 107 gas
3. Gas from stripper wells
4. Gas under Secs. 102, 103, and 109 of the NGPA and,
5. Old, flowing gas.

It is estimated that, on average, no more than six percent of the gas purchased by 29 interstate pipelines is "decontrolled," high-cost gas. The highest percentage is approximately 10%, while some pipelines have purchased very small quantities of this most expensive gas. However, at the present time, pipelines may have reduced the average price of purchased gas, but, by exercising "market-out" clauses, they have not substantially reduced the high annual "take" obligations under the gas contracts.

This means that there can be a significant difference in the cost of purchased gas of each of the pipelines. To the extent that any pipeline has purchased large quantities (up to 10% of initial supply) from the highest priced gas, or has substantial quantities of high-cost gas from intercompany transfers or imports, it will tend to have a higher average cost of supply under Secretary Hodel's Bill than a more conventional pipeline purchasing most of its gas from domestic producers and exercising more prudence in the quantity of high-priced gas which it may have purchased. Those high average cost pipelines may not have to ask for FERC hearings on adjustments for increased purchased gas costs when the Natural Gas Policy Act Reform Bill "caps" lower, domestic renegotiated prices during the decontrol.

With the construction of the long pipelines in the 1940's and the 1950's to bring gas to the upper Middle West and East Coast areas from the Gulf Coast, contracts were offered for the first time with firm "take" obligations. Even though these contracts provided for purchasing gas at a constant rate over 20 years, they were superior to the earlier contracts in which the purchasers promised to buy no particular quantity of gas at all. By the early 1970's, when the long-term decline in drilling activity began in the United States, contracts were offered, particularly by the intrastate pipelines, that essentially promised to take an annual average of 80-90% of all the gas that the wells could deliver. By the mid-1970's, the intrastate pipelines began to raise their prices as gas demand grew. In a short period of time, they increased natural gas purchase prices from around 20¢ per million Btu to nearly $2.00 per million Btu. When the interstate pipelines entered the marketplace at the end of 1978 (with the Natural Gas Policy Act), they had to offer the same prices to producers as the intrastate pipelines. Since the interstate pipelines were experiencing deliverability shortfalls, they offered contracts with very high "takes." They continued to buy gas with the expectation that any excesses could be sold to another interstate pipeline in another region of the country.

All went well until the economic downturn and the sharply reduced demand for natural gas. The pipelines were left with fixed contract obligations for purchases from other pipelines, for fixed obligations with regard to "takes" of costly imports and with high contractual obligations for costly decontrolled gas and other 107 categories. As a consequence, pipelines cut back on their old flowing gas which was cheaper but where the long-standing contracts had much less favorable provisions to the producer concerning "takes."

Consequently, if we were to look at the average cost of domestic pipeline purchases of gas and its impact on the cost to the retail consumer, we will find that, as the economic recovery continues, the cost of wellhead gas will go down due to the shift to older, flowing gas at lower prices, and to the renegotiation of contracts as well as the exercise of "economic-out" provisions on high-cost gas by the pipeline purchasers. However, there may be no comparable reduction in total average cost if other expensive sources of gas like imports and gas purchased from another pipeline significantly increase in volumes.

General Effects of Natural Gas Policy Act Reform on Diversified Independent Producers

CONTRACTS

Petro-Lewis will have to re-negotiate approximately 3,000 contracts, none of which are really standard. Each property has different characteristics including royalty interests, future drilling commitments to retain leases, "old" gas prices, "new" gas prices, maturity dates, and other associated assets like gas plants, field pipelines, condensate, etc. It may require a doubling of our staff to renegotiate these contracts in a year. We cannot estimate what percentage of pipelines may decide to exercise their right to only take 70% of deliverability, thus leaving us with 30% to market eslewhere. Nonetheless, a staff effort would have to be launched to locate other pipelines or industrial customers in the region who could buy such gas. It would take us even more time to develop a national marketing network to exchange gas among different regions.

We expect that large customers like utilities and industrial companies would also have to beef up staff to be able to effectively deal with a national gas market, rather than a limited regional one. Small gas customers may have real difficulty in negotiating advantageous prices, compared to the larger customers, given their inexperience in purchasing and limited staffing.

GAS TAKES

Gas "takes" experienced by Petro-Lewis are currently running at about 50-70% of deliverability, depending on the region. The Gulf Coast, the hardest hit region, has seen takes down to 50% recently, but most other areas are running at 70%+. However, it should be remembered that the Gulf Coast supplies most of the gas in interstate commerce, and low "takes" reflect the depth of the industrial recession as well as fuel-switching by industrial customers.

Under proposed Sec. 111, Paragraph (e) of the reform bill, there is a requirement for reporting within five days the date that the contract is executed or amended. Under current business practice, the pipeline may send the signed contract to the producer, have the producer execute it, and at that time it would become effective. Often there is a different effective date in the contract than the date on which either buyer or seller sign. We are concerned that in order to comply, the pipelines may require that they be the last to execute the contracts.

The producer, on the other hand, will not have any assurance that the contract will, in fact, be executed. Delays in that kind of situation are not unknown. Producers would feel far more comfortable when the contract is executed by the pipeline first and then sent back to the producer. The Bill's language could be modified to simply provide that, within five days from the date that the pipeline purchaser is aware that the contract has been executed, it shall report to the FERC.

Section 302, paragraph (c), may need some clarification. It provides that the seller shall have the right to terminate the contract with respect only to the "incremental" amounts not taken, above the 70% maximum level and below the contract's previous deliverability level. It is our understanding and experience that the "take" obligation is an obligation which is averaged over the year, and that on any given day, the purchaser may buy a substantially greater or smaller quantity. It would be very difficult for us as a producer to negotiate any new sales arrangement with another purchaser when the quantity of gas available would be indefinite on a daily basis. It would be better if the Reform Bill stated that a specific amount of the gas was released.

In most contracts today, the purchaser provides that he shall protect the seller from drainage losses. Often the seller does not seek an action or damages for drainage when it is receiving an equivalent sum of money under a "take-or-pay" provision. The seller probably does not experience any net drainage over time, if the purchaser increases its "takes" in later years so that the entire contractual quantity of gas is sold over time. However, if the purchaser never sufficiently increases his takes to offset the net loss through drainage, then the seller is entitled to keep a portion of the take-or-pay monies reflecting the drainage loss and the buyer's failure to purchase a sufficient quantity of gas to offset this net migration over time. We believe that Section 316, paragraph (c), should be modified to reflect how contracts really function, limiting the seller's obligation to reimburse the buyer for the gas not taken.

DRILLING

The drastic decline in gas drilling so far this year accounts for most of the 47% decline in total US drilling, according to the Oil & Gas Journal. This reduction stems from tumbling corporate cash flows that result from reduced "takes" and limited "pays." At the same time banks are requesting debt paydowns from oil and gas companies, and are making new loans more diffcult to get as well as smaller in amount. The returns on finding new marginal gas supplies are shrinking fast because these gas prices are declining. As drilling rigs operating now decline in number, gas well completions will soon follow suit. Already, drilling for deep gas in the Tuscaloosa and Anadarko Basins has ceased. As demand for gas grows with economic recovery and new reserves are not found, costly imports are likely to fill any domestic shortages in gas deliverability that develops in the next 3-4 years.

Technical Questions about the Reform Bill

GAS CAP

As Petro-Lewis understands the purpose of the gas cap, it is supposed to represent the real market-clearing price for gas during the decontrol transition. It should encompass the level that prices would seek as buyers and sellers bargain in the open marketplace of new and renegotiated contracts. However, as calculated, the gas cap price would be a volume-weighted average. If very old contracts for large gas volumes are renegotiated for only a few cents higher price in exchange for mutual agreement that they will be completely decontrolled in 1986 as is contemplated by the Bill, this behavior may tend to pull the "average" price down, making it unrepresentative of the real market-clearing price. Also, the gas cap may be very difficult to calculate because of the mass of estimated data on volumes sold and prices charged under renegotiated contracts. It would be much easier to report prices negotiated in each area or region and calculate the modal (most frequently quoted) price on contracts, using that price as the gas cap during 1984-85. However, imported gas prices should not be ignored.

The overall problem of imports should be considered within the context of the bill. Somehow, incentives should be offered to encourage the purchase of lower-cost domestic supplies and to displace imports with domestic supply as much as possible. It seems to make little economic sense to have domestic supplies of gas in California shut-in with "takes" as low as 20% of deliverability, while purchases are made by California utilities at the Canadian border for gas which, when delivered, costs nearly twice as much. Petro-Lewis is sure that Congress does not intend for the gas cap to result in a lower average wellhead price for gas in the United States while at the same time providing no relief to the retail consumer, due to the increasing cost of imports and intercompany purchases by pipelines which are excluded from the gas cap.

Proposed Sec. 121, on the elimination of price controls for certain natural gas sales, needs a little clarification for high cost gas. The gas cap price is the price in effect prior to the exercise of any "market-out" provision by the purchaser. If not, then those sellers who agree to the inclusion of market-out clauses in their contracts will be doubly penalized.

With respect to Paragraph (b) of Sec. 318, we believe that Congress' intent is that the gas cap represent the real market-clearing price, better calculated as the modal price, rather than the volume-weighted average of all prices. This would constitute a more equitable and realistic area rate. With regard to indefinite price escalator clauses, they are meant to provide a price over time which approximates the then-going price for gas and would not be needed during decontrol transition if the gas cap is appropriately calculated.

PIPELINE AVERAGE COST PLUS INFLATION AS LIMIT ON PURCHASED GAS ADJUSTMENTS

Limiting purchased gas adjustments to a pipeline's average cost as of the date of the Bill's enactment plus inflation during the decontrol transition period (1983-86) will reward high-cost pipelines for their inability to locate cheaper supplies and will lock in their cost basis, permitting them more flexibility in switching among sources of supply compared lower cost pipelines. More prudent, low-cost pipelines would be penalized by the fact that any reserve additions and newer supplies will significantly raise their average costs and force them into what could be a more time-consuming FERC review.

Also, using the GNP price deflator as a measure of inflation, or as Secretary Hodel's bill proposes, using percentage change in the US gas cap price as "inflation", would put additional pressures on pipelines during the decontrol transition to ignore the depleting nature of natural gas, and to forget about the difficulty of locating and developing more costly, marginal supplies in the longer-term. During those decontrol transition years, drilling and completion rates for new gas wells will fall. Then the current surplus in gas deliverability will disappear if we have any kind of economic recovery.

Pipelines under this kind of regulatory pressure may try to shift their cost uncertainty back to wellhead producers, saying all prices paid will be subject to FERC approval and/or refund according to the outcome of rate cases. This uncertainty will also negatively impact new drilling and future gas supplies, raising corporate investment hurdle rates and making bank project-financing more difficult.

If pipelines remain public utilities, they will have to line up future production and reserves to meet their customers' needs. Merrill Lynch, in a recent gas study, stated that half of all future supplies will come from 107-type gas. We also believe this to be true. In time, pipelines will have to carry these gas costs along to ultimate consumers.

As another point for clarification, proposed Sec. 603 should refer to pipeline as an interstate pipeline that must seek the purchased gas cost adjustment. This would appear to be the Bill's intent, since it is the data only with respect to interstate pipelines upon which the national base is set up. Also it is only the interstate pipelines that compute their average gas cost for FERC regulatory purposes.

Repeal of NGPA's Non-price Regulations

If the Fuel Use Act, incremental pricing regulations, and PURPA are repealed, industrial and utility demand for natural gas will increase and the load factor on the pipeline system should rise. These large customers would then bear far more of the fixed cost of the utility system, and this factor alone will account for more cost savings on behalf of retail consumers than anything else. Petro-Lewis welcomes the chance to compete with other producers to supply the demands of industry or utilities.

Current gas supplies and deliverability appear adequate for 1983-84, and domestic gas prices will probably be reduced by 10-25% in the next 6-12 months under Secretary Hodel's bill, through renegotiation of take-or-pay obligations, prices, and greater takes under older contracts. A modal gas cap price and simplified FERC reporting would leave producers and pipelines free to concentrate on re-vitalizing contracts, adding flexibility while maintaining long-term business relationships. While most analysts predict that drilling will suffer in 1983-84, it will pick up in 1985-86 as demand for gas presses against available current supplies.

APPENDIXES

Table 1 Distribution of Petro-Lewis' Natural Gas Production

Table 2 Gas Purchases - 20 Major Interstate Pipelines

Table 3 Natural Gas Reserves and Production: Total United States for 1945-1981

Table 4 Natural Gas Reserves and Production: Lower 48 States for 1945-1981

Table 5 Market/Consumption

Table 6 Natural Gas Prices

Table 7 Natural Gas Imports

ARTICLE 1 Survey of Industrial Fuel Switching and Alternative Fuel Capability, 1981-82 (Update)

ARTICLE 2 Natural Gas Production Capability

ARTICLE 3 Fuel Switching by Industrial and Electric Utility Gas Users: An Overlooked National Issue

ARTICLE 4 A Statistical Analysis of Bidding Trends for Decontrolled Natural Gas Under the NGPA

ARTICLE 5 Mexican Gas Supplies to the United States

ARTICLE 6 Recent and Potential Substitution of Oil with Gas and Coal in Non-Transportation Uses

ARTICLE 7 Natural Gas Prices and the Economic Problems of Deregulation

Table 1

Distribution of Petro-Lewis' Natural Gas Production

	"Old"	"New"	
Petro-Lewis & Partners	60%	40%	Gas Compliance Department
PLPC I	70	30	
PLPC II	55	45	
Subsequent Partnerships	60	40	
Partnerships 82-11 to 83-2		100	
US Average	56*	44	(FERC data)

* 6%/year decline in production

NOTE: "Old" = Sections 104, 106, 108 of Natural Gas Policy Act

"New" = Sections 102, 103, 107, 109 of Natural Gas Policy Act

TABLE 2: GAS PURCHASES - 20 MAJOR INTERSTATE PIPELINES

Table I
Gas Purchases—20 Major Interstate Pipelines

	Mid-1981				Late 1981 - Early 1982				Mid-1982			
		Percent of Volumes				Percent of Volumes				Percent of Volumes		
	Total Purchases (BCF)	Old Gas	New Gas	High Cost	Total Purchases (BCF)	Old Gas	New Gas	High Cost	Total Purchases (BCF)	Old Gas	New Gas	High Cost
Cities Service	344	60	38	2	303	55	40	5	236	50	43	6
Colorado	281	52	36	11	287	49	38	11	292	46	41	12
Columbia	597	46	52	1	678	38	52	9	633	41	48	10
Consolidated	104	33	67	*	102	28	72	*	102	28	72	*
El Paso	1,015	59	37	3	1,013	52	44	4	1,132	47	44	8
Florida	137	64	26	10	132	65	28	6	118	69	23	8
Kansas-Nebraska	76	74	21	5	70	69	26	5	63	63	32	4
Michigan-Wisconsin	540	71	26	3	583	66	27	7	547	67	24	9
Natural	848	78	22	*	863	74	25	*	900	71	29	*
Northern	727	60	39	*	705	61	38	1	683	60	38	2
Northwest	135	59	40	*	156	53	46	1	162	46	50	4
Panhandle Eastern	511	70	29	1	520	63	36	1	524	61	37	1
Southern	453	55	30	15	445	56	32	12	458	52	39	9
Tennessee	1,037	76	23	*	1,075	70	27	2	1,094	61	33	6
Texas Eastern	554	81	19	*	509	80	20	1	485	81	18	1
Texas	468	69	25	6	459	70	22	8	451	68	22	10
Transcontinental	849	38	51	11	844	42	47	10	879	41	48	11
Transwestern	269	68	31	1	268	60	36	4	297	42	43	15
Trunkline	591	68	22	10	578	68	23	9	589	65	26	8
United	633	53	44	3	670	51	45	4	705	44	51	5
Total	10,169	62	33	4	10,260	59	35	5	10,350	56	37	6
Average Price ($ per MCF)	2.01	1.24	2.96	6.12	2.19	1.27	3.01	7.33	2.35	1.29	3.09	7.24

Note: Totals may not add due to exclusion of miscellaneous gas purchases and rounding.
Volumes based on projected purchases from PGA filings.
**Less than 0.5 percent.*
Source: DOE

TABLE 3 Natural Gas Reserves and Production: Total United States for 1945-1981

	Year	*Annual Gross Additions to Proved Reserves*	*Cumulative Discoveries*	*Preliminary Annual Net Production**	*Cumulative Net Production*	*Proved Reserves*	*Gas In Underground Storage***	*Proved Reserves/ Annual Production Ratio*
		Tcf at 60°F and 14.73 psia						
A.G.A.	1945	—	233.18	—	86.35	146.99	0.15	—
	1950	11.99	300.15	6.86	115.91	184.58	0.34	26.91
	1955	21.90	382.17	10.06	161.05	222.48	1.36	22.12
	1956	24.72	406.89	10.85	171.90	236.48	1.49	21.80
	1957	20.01	426.89	11.44	183.34	245.23	1.67	21.44
	1958	18.90	445.79	11.42	194.76	252.76	1.73	22.13
	1959	20.62	466.41	12.37	207.13	261.17	1.89	21.11
	1960	13.89	480.31	13.02	220.15	262.33	2.17	20.15
	1961	17.17	497.47	13.38	233.53	266.27	2.33	19.90
	1962	19.48	516.96	13.64	247.17	272.28	2.49	19.96
	1963	18.16	535.12	14.55	261.71	276.15	2.74	18.98
	1964	20.25	555.37	15.35	277.06	281.25	2.94	18.32
	1965	21.32	576.69	16.25	293.31	286.47	3.09	17.63
	1966	20.22	596.91	17.49	310.81	289.33	3.22	16.54
	1967	21.80	618.72	18.38	329.19	292.91	3.38	15.94
	1968	13.70	632.41	19.37	348.56	287.35	3.49	14.83
	1969	8.38	640.79	20.72	369.28	275.11	3.60	13.28
	1970	37.20	677.99	21.96	391.24	290.75	4.00	13.24
	1971	9.83	687.81	22.08	413.32	278.81	4.31	12.63
	1972	9.63	697.45	22.51	435.83	266.08	4.47	11.82
	1973	6.83	704.27	22.61	458.44	249.95	4.12	11.05
	1974	8.68	712.95	21.32	479.76	237.13	3.94	11.12
	1975	10.48	723.43	19.72	499.48	228.20	4.24	11.57
	1976	7.56	730.99	19.54	519.02	216.03	4.05	11.06
	1977	11.85	742.84	19.45	538.47	208.88	4.50	10.74
	1978	10.59	753.43	19.31	557.78	200.30	4.65	10.37
	1979	14.29	767.72	19.91	577.69	194.92	4.89	9.79
DOE	1976	—	N/A	—	N/A	213.28	N/A	—
	1977	12.98	N/A	18.84	N/A	207.41	N/A	11.01
	1978	19.43	N/A	18.81	N/A	208.03	N/A	11.06
	1979	12.22	N/A	19.26	N/A	201.00	N/A	10.44
	1980	16.72	N/A	18.70	N/A	199.02	N/A	10.64
	1981	21.45	N/A	18.74	N/A	201.73	N/A	10.76

Note: The small inconsistencies between annual and cumulative discoveries and between annual and cumulative production are caused by rounding of values.

*Preliminary net production was reported annually by the Committee on Natural Gas Reserves. Adjustments to these preliminary numbers are included in the revisions which are reported in the following year. Actual annual production and cumulative production are tabulated for the years 1965 through 1974 in "Reserves of Crude Oil, Natural Gas Liquids and Natural Gas in the United States and Canada as of December 31, 1975".

**Proved recoverable gas contained in underground storage reservoirs (first reported on a recoverable basis in 1973).

Source: AGA, Gas Energy Review, 2/83

TABLE 4 Natural Gas Reserves and Production: Lower 48 States for 1945-1981

Tcf at 60°F and 14.73 psia

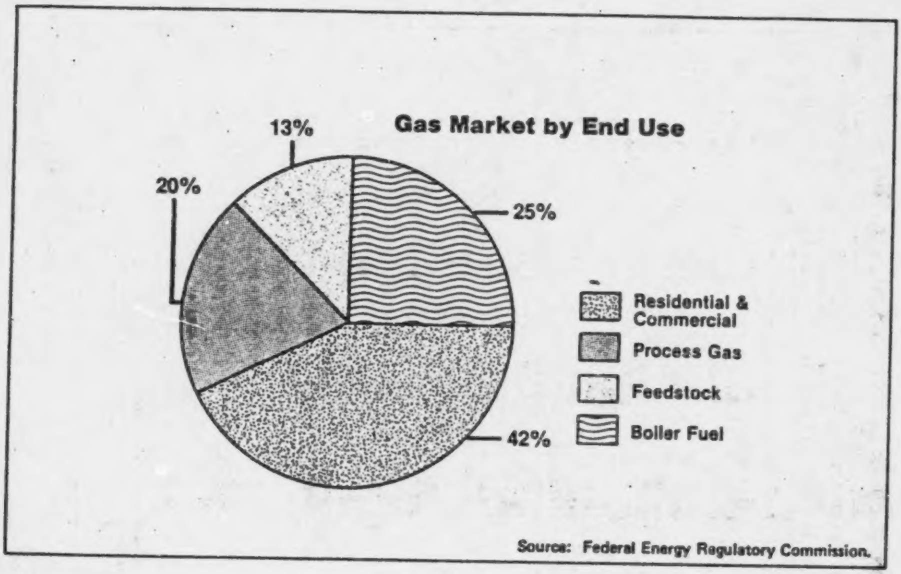
	Year	Annual Gross Additions to Proved Reserves	Cumulative Discoveries	Preliminary Annual Net Production*	Cumulative Net Production	Proved Reserves	Gas In Underground Storage**	Proved Reserves/ Annual Production Ratio
A.G.A.	1945	—	233.18	—	86.35	146.99	0.15	—
	1950	11.99	300.15	6.86	115.91	184.58	0.34	26.91
	1955	21.90	382.17	10.06	161.05	222.48	1.36	22.12
	1956	24.72	406.89	10.85	171.90	236.48	1.49	21.80
	1957	20.01	426.89	11.44	183.34	245.23	1.67	21.44
	1958	18.90	445.79	11.42	194.76	252.76	1.73	22.13
	1959	20.56	466.35	12.37	207.13	261.11	1.89	21.11
	1960	13.84	480.20	13.02	220.15	262.22	2.17	20.14
	1961	16.35	496.55	13.38	233.53	265.35	2.33	19.83
	1962	18.77	515.32	13.64	247.16	270.64	2.49	19.84
	1963	18.10	533.42	14.54	261.70	274.46	2.74	18.88
	1964	20.11	553.52	15.34	277.04	279.42	2.94	18.22
	1965	21.16	574.68	16.24	293.29	284.48	3.09	17.52
	1966	19.25	593.93	17.48	310.77	286.39	3.22	16.38
	1967	21.09	615.02	18.36	329.13	289.27	3.38	15.76
	1968	12.04	627.06	19.33	348.45	282.10	3.49	14.59
	1969	8.34	635.40	20.64	369.09	269.91	3.60	13.08
	1970	11.12	646.52	21.82	390.91	259.62	4.00	11.90
	1971	9.44	655.96	21.92	412.83	247.44	4.31	11.29
	1972	9.40	665.36	22.37	435.20	234.63	4.47	10.49
	1973	6.51	671.86	22.47	457.67	218.31	4.12	9.72
	1974	8.31	680.17	21.17	478.85	205.27	3.94	9.69
	1975	10.14	690.32	19.56	498.41	196.15	4.24	10.02
	1976	7.45	697.77	19.32	517.73	184.10	4.05	9.53
	1977	11.76	709.53	19.26	536.99	177.05	4.50	9.19
	1978	10.59	720.12	19.10	556.69	168.69	4.65	8.83
	1979	13.73	733.85	19.69	576.38	162.98	4.89	8.28
DOE	1976	—	N/A	—	N/A	180.84	N/A	—
	1977	12.97	N/A	18.64	N/A	175.17	N/A	9.40
	1978	19.41	N/A	13.59	N/A	175.99	N/A	9.47
	1979	11.78	N/A	19.03	N/A	168.74	N/A	8.87
	1980	15.39	N/A	18.49	N/A	165.64	N/A	8.96
	1981	21.56	N/A	13.50	N/A	168.69	N/A	9.12

Note: The small inconsistencies between annual and cumulative discoveries and between annual and cumulative production are caused by rounding of values.

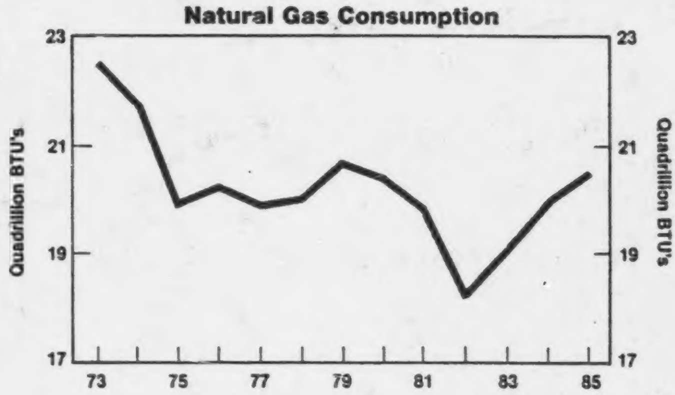
*Preliminary net production is reported annually by the Committee on Natural Gas Reserves. Adjustments to these preliminary numbers are included in the revisions which are reported in the following year. Actual annual production and cumulative production are tabulated for the years 1965 through 1974 in "Reserves of Crude Oil, Natural Gas Liquids and Natural Gas in the United States and Canada as of December 31, 1975."

**Proved recoverable gas contained in underground storage reservoirs (first reported on a recoverable basis in 1973.)

Source: AGA, Gas Energy Review, 2/83

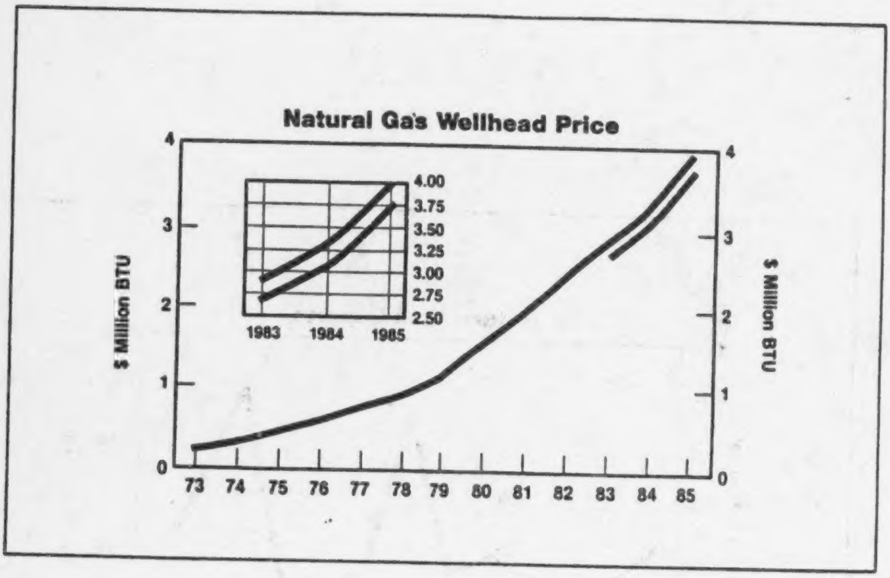


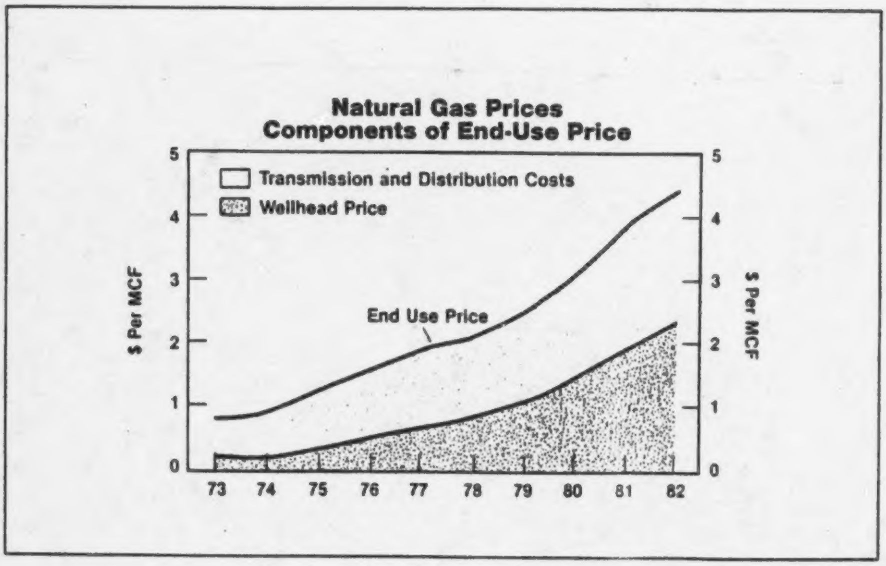
Source: Federal Energy Regulatory Commission.



Source: Merrill Lynch, 1/83, Natural Gas Industry: Outlook for 1983

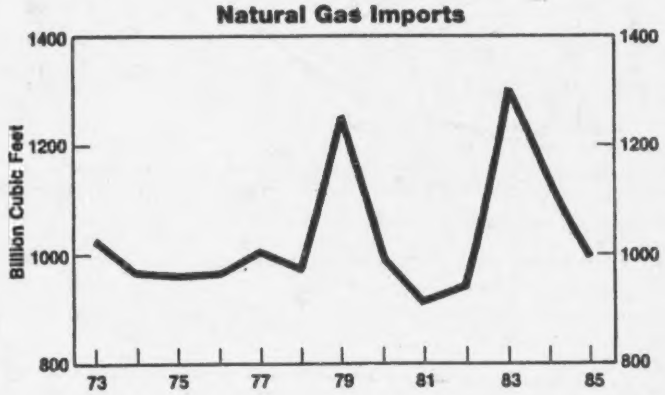
Table 6





Source: Merrill Lynch, 1/83, Natural (
Industry: Outlook for 1983

Table 7



Source: Merrill Lynch, 1/83, Natural Gas Industry: Outlook for 1983

ARTICLE 61

Survey of Industrial Fuel Switching and Alternative Fuel Capability, 1981-82 (Update)

by Richard L. Itteilag
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and

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In Brief

A.G.A. conducted a survey of member gas companies around the country to provide a general outlook on the current demand situation for natural gas, relative to other fuels in the industrial market. The survey indicates that gross fuel switching from gas to oil in 1981 and 1982 in the industrial and electric utility markets could reach as high as 659 Bcf, the equivalent of 330,000 barrels per day of oil (exclusive of any switching to gas from oil).

This article reproduces in its entirety, the American Gas Association's analysis entitled, "Survey of Industrial Fuel Switching and Alternative Fuel Capability, 1981-82 (Update)," (Energy Analysis 1982-12, Sept. 3, 1982).

Introduction

The industrial market for natural gas is important to the regulated gas industry in that 53% of gas sales are to industrial users (including electric utilities). Gas sales in this market are very price sensitive because many users have the capability to easily switch to alternative fuels. Fuel switching from (or to) gas to (or from) fuel oil, coal and liquefied petroleum gas (LPG) is often the result of the price sensitivity of the industrial market—although a number of other factors also influence an industrial user's fuel choice.

Previous A.G.A. surveys on the relationship between oil and gas use in industry have focused on varying aspects of interfuel competition, such as the added impact of regulatory impediments on gas. A survey conducted a little over a year ago indicated that displacements of oil by gas in the industrial market (including electric generation) reached a net level of 456,000 barrels per day in 1980 compared to a 1978 base year. However, current indicators are that this trend is reversing (i.e., gas is now losing load to oil and oil-to-gas fuel switching is decreasing). Part 1 of this analysis updates the information on actual losses to oil in 1981 and the market and regulatory factors that accounted for this fuel switching.

Part 2 of the survey also requested data on gas-to-oil fuel switching. This section requested actual data on gas-to-oil load losses for the period from January through May 1982 and projected load losses to oil through the rest of the year.

The purpose of this analysis is to provide a general outlook on the current demand situation for natural gas, relative to other fuels in the industrial market — including existing and potential fuel switching.

Executive Summary

- A survey of A.G.A. member gas companies around the country indicates that *gross* fuel switching from gas to oil in 1981 and 1982 in the industrial and electric utility markets could reach as high as 659 Bcf, the equivalent of 330,000 barrels per day of oil (exclusive of any switching to gas from oil), by the end of 1982. *Net* fuel switching from gas to oil (subtracting gains made by gas from oil) totalled 515 Bcf (258,000 barrels per day) over this period.
    1. Actual losses to oil (including LPG) in 1981 were 295 Bcf, the equivalent of 148,000 barrels per day. Over the January through May 1982 period, an additional 226 Bcf/year were lost to oil, or 113,000 barrels per day equivalent. It is projected that this will increase to 364 Bcf/year by year-end, or 182,000 barrels per day equivalent.
    2. Survey respondents also indicated that *gross* fuel switching from oil to gas (oil displacements) of 144 Bcf, or a rate of 72,000 barrels per day, occurred over the 1981-82 period. In 1981, 66,000 barrels per day of oil were displaced by gas and only an additional 6,000 barrels per day of displacements are expected in 1982.
    3. Thus, *net* fuel switching from gas to oil (subtracting total gains of 144 Bcf from total losses of 659 Bcf) over the 1981-82 period totalled 515 Bcf, or *net* losses to oil from gas of 258,000 barrels per day.
- The primary reasons for these losses to oil were price competition, take-or-pay contract obligations of industrial and electric utility users to purchase oil, and inflexible pricing regulations on natural gas, such as incremental pricing.
    1. The impact of gas price increases under NGPA wellhead pricing provisions was the major factor, particularly with regard to the projected losses to oil in 1982.
    2. The price differential between gas and oil, causing the switching to oil, ranged from 5-15% lower for residual oil versus gas and as much as 18-27% lower for LPG versus gas.
    3. Take-or-pay contractual obligations of energy consumers to purchase oil also accounted for a large share of the losses to oil, especially in the electric generation sector in 1981.
- Between 1978 and 1980 the gas utility industry displaced oil use in the industrial and electric generation markets at the *net* rate of 456,000 barrels per day. Given the updated data for 1981, net oil displacements since 1978 have declined again in 1982 to a net rate of approximately 198,000 barrels per day.
- According to survey respondents, approximately 52% of 1981 gas sales in the industrial sector were to dual-fuel capable users, whereas over 89% of electric generation sales were to dual-fuel capable users.
    1. In the industrial sector, residual oil was the primary alternative fuel for 49% of the dual-fuel capable use followed by distillate oil, 36%, and LPG, 15%.
    2. In the electric generation sector, residual oil was the primary alternative fuel for nearly all of the dual-fuel capable users.

Source: AGA *Gas Energy Review*, 11/82

ARTICLE 1 con't

TABLE 1

Percentage of 1981 Gas Use in Dual-Fuel Facilities vs. Total Gas Use, By Region and Total U.S.

(Based on 37 survey respondents)

Region	*Industrial*	*Electric Generation*	*Combined*
New England	52%	100%	60%
Middle Atlantic	41	48	43
East North Central	32	38	32
West North Central	73	83	74
South Atlantic	83	100	84
East South Central	86	*	86
West South Central	23	100	49
Mountain	100	*	100
Pacific	79	99	91
United States	52	80	62

TABLE 2

Percentage of 1981 Gas Use in Dual-Fuel Capable Facilities By Alternative Fuel, By Region and Total U.S.

(Based on 37 survey respondents)

Region	*Industrial*			*Electric Generation*	
	Distillate	*LPG*	*Residual Oil*	*Distillate*	*Residual*
New England	8%	2%	90%	100%	0
Middle Atlantic	41	8	51	22	78
East North Central	29	2	69	50	50
West North Central	40	16	44	42	58
South Atlantic	25	39	36	58	42
East South Central	46	20	34	*	*
West South Central	46	1	53	0	100
Mountain	85	0	15	*	*
Pacific	42	15	43	3	97
United States	36	15	49	6	94

*No reported electric generation sales by companies surveyed.

Implications of Results

The gas utility industry has lost substantial volumes of load to oil in 1981 and 1982 in the industrial market, offsetting only a fraction of these losses through displacements of oil by gas. Moreover, while in 1981 gas utility industrial sales increased compared to 1980,[2] it appears that industrial gas sales in 1982 will be down from 1981 under the combined efforts of the economic recession and fuel switching to oil. Preliminary sales statistics show that gas utility sales in the industrial market were 24% lower in May 1982 compared to May 1981,[3] 23% lower for June 1982 versus June 1981 and 13% lower for the six months from January through June 1982 compared to the first six months of 1981.[4]

Given the results of this analysis that identifies the capability of many industrial users to readily switch between gas and oil and gas load losses to oil that have already occurred, it appears that gas will face stiff competition in the industrial sector as wellhead prices are decontrolled. At present, gas utilities — which are regulated by state public utility commissions — do not have the pricing flexibility that sellers of alternative fuels enjoy. If gas utilities are to optimize their sales in this market, they should be on an equal footing with their competitors in terms of pricing flexibility. Where gas utilities can not price their product to meet the competition, load loss will occur. ☐

ARTICLE 1 Cont'd.

TABLE 3

Actual Gas-to-Oil Fuel Switching
(January-May, 1982)

Actual Losses	*Month*	*Fuel*	*Price*	*Gas Rate*
(Bcf/year)			*($/MMBtu)*	*($/MMBtu)*
0.02	March	#2	(to keep access to supplier)	
0.06	April	LPG	3.58	4.35
3.10	Jan.	#6	3.73	3.91
0.03	May	LPG	5.90	6.25
6.00	Jan.-Apr.	#6	—	—
0.13	April	LPG	4.18 4.46	4.69 6.10
18.10	May	#6	4.80	5.21
57.00	May	#6	4.00-5.00	5.26
0.50	Jan.-Apr.	#6	3.03	3.56
0.50	April	#6	4.60	5.14
0.30	Feb.-Apr.	#6	N/A	3.54
0.10	March-Apr.	#6	(differential of $0.37/MMBtu)	
3.00	Jan.Apr.	#6	($4.82 Jan. 4.47 Apr.)	4.48 4.70
0.30	Jan.-Apr.	LPG & #6	3.25 4.00-4.25	4.47
5.20	Jan.Apr.	#6	N/A	4.50
0.65	Jan.	#6	3.68	3.98
94.65				

TABLE 4

Projected Load Loss to Oil
(June-December, 1982)

Additional 1982 Projected Loss	*Fuel*	*Comment*
(Bcf/year)		
1.30	#6	A gas cost adjustment scheduled for August 31 would raise the gas price above the current residual oil price. This potential loss could actually be as high as 6.9 Bcf if industrial activity was not at such depressed levels.
0.25	#6, coal, LPG	60% of the projected loss is to coal.
6.30	#6	Initial losses projected for late Fall.
0.05	#6 and LPG	N/A
2.02	#6	Primarily interruptible. Although interruptible tariff contains a provision prohibiting gas from exceeding oil price, minimum gas price must be above commodity cost.
0.01	LPG	Customer purchased LPG on spot market; may displace gas or may be used when interrupted.
3.00	#6	Delayed effect of rate increase and possible effect on summer agriculture load.
4.00	#6	Loss commences October 1.
4.40	#6	Three plants to switch. The first expected in mid-July.
6.30	#6	Anticipated effect of a September gas cost increase.
24.20	#6	Includes large commercial customers.
0.70	#6	N/A
5.60	#6	Losses to occur in more than one state.
0.85	#6	Predicated on continuation of residual oil glut.
58.95		

ARTICLE #2

Natural Gas Production Capability

by Robert B. Kalisch
Director, Gas Supply and Statistics
American Gas Association

In Brief

Reduced demand for natural gas as a result of recent business conditions, coupled with increased delivery capability, has led to the significant shutting in of natural gas production (the gas "bubble"). There has been some speculation about the capability for increasing gas production when gas demand returns to more traditional levels. The purpose of this article is to examine gas production capability for 1982 and determine the size of the gas bubble. Two estimates of unused production capability in 1982 are derived from currently available data. The results indicate that there was between 1.9 and 2.7 trillion cubic feet (Tcf) of unused production capability in 1982. This unused capacity excludes the nearly 1 Tcf of Canadian gas under contract and not taken.

Introduction

At mid-year 1982, gas utility sales and total natural gas consumption were below 1981 levels. The economic recession, the very competitive pricing of oil products in some regions and conservation have softened gas sales, especially in the industrial boiler market. This fall-off in demand has caused a decline in gas production. However, in 1982 additional production could have been achieved because of higher gas exploration and production activity. This article develops two methodologies that can be employed to quantify that unused production capability.

Methodology

Two methods of estimating the maximum production capability have been developed. The first method is based on the extrapolation of individual gas well production trends. With this technique the average gas well production trend from 1966 to 1981 is extrapolated to create an estimated production per gas well for 1982. This extrapolation together with an estimate of the number of producing gas wells for 1982 yields an estimate of total production capability. The problem with this method is that it assumes no excess deliverability existed prior to 1982. It therefore measures *only* the incremental increases in the gas bubble between 1981 and 1982.

The second method is based on the assumption that the maximum production capability (or very close to it) is achieved at some time during the winter heating season. The highest dry gas production per month is tabulated from the Department of Energy's *Monthly Energy Review.* The implied daily production capability is calculated by dividing the monthly data by the number of days in the relevant month and then multiplying this daily production by 365. This method produces a different estimate than the first method.

The first method is preferred in that it is based on yearly production history. Therefore, typical low production levels during the summer months (slack demand season) already are embodied in that estimate. The latter method assumes that the peak production is actually reached for a calendar month and that the peak level of production could be maintained for 12 months.

These two methods are useful in that the assumptions are different and thus tend to cross check each other. By subtracting the actual production from these estimates a reasonable range of unused available production capability can be formulated.

Maximum Production Capability

The estimates developed here are intended to evaluate what production levels might be achieved with wells already drilled and attached to pipelines. Some additional capacity also exists in wells that are capable of gas production but have not been completed or are not connected to a pipeline. In addition, there are large volumes of gas that are behind the pipe' (as gas not being produced because production from that well is presently coming from other depths). In both situations these volumes of gas represent a capability that is not utilized because the optimization of hydrocarbon production requires that

Source: AGA Gas Energy Review, 2/82

TABLE 1 Production Per Gas Well

Year	*Non-Associated Gas Production in Bcf*	*Producing Gas Wells*	*Annual Non-Associated Gas Production per Gas Well MMCF*
1966	12,926	112,496	114.9
1967	13,639	112,321	121.4
1968	14,740	114,391	128.9
1969	15,972	114,476	139.5
1970	17,115	117,483	145.7
1971	17,062	120,210	141.9
1972	17,693	121,153	146.0
1973	17,124	123,034	139.2
1974	16,613	126,329	131.5
1975	15,389	132,095	116.5
1976	15,259	137,443	111.0
1977	15,560	147,658	105.4
1978	15,737	157,454	99.9
1979	16,320	169,891	96.1
1980	16,172	182,004	88.9
1981	16,122	198,839	81.1
1982	16,726 (Est)	217,221[1]	77.0[2]

Sources: A.G.A., *Reserves of Crude Oil, Natural Gas Liquids, and Natural Gas in the United States and Canada as of December 31, 1979*; EIA, *Monthly Energy Review*; EIA, *U.S. Crude Oil, Natural Gas Liquids Reserves and Historical Statistics 1966-1978.*

[1] This estimate is based on a least squares estimate of abandoned gas wells, annual gas well completions and producing gas wells as follows: (producing gas wells) = (producing gas wells as in 1981) + (estimated gas wells completed in 1982) − (least squares estimate of abandoned gas wells) = 217,221. Gas well completions were based on the extrapolation of nine months of data available in 1982.

[2] Estimated from data in this table and data plotted in Figure 1. If only the years 1975 through 1979 are used for this estimate, the production per gas well estimate would be 79.8 MMcf. This estimate would take into account that in 1980 and 1981 some excess production capability existed.

these reserves be left in place at this time.

The estimates developed here include only gas that comes from reservoirs currently capable of production and connected to pipelines. A larger volume could be produced under different operating conditions such as a very large unsatisfied demand for gas. The estimates in this article are based on the production capability if demand were only marginally higher than current levels.

Table 1 and Figure 1 provide the statistical data necessary to develop estimates of non-associated gas production capability for 1982. The extrapolated 77 MMcf annual production per gas well multiplied by a total of 217,221 producing gas wells yields a non-associated gas production capability of 16,726 Bcf. Recent levels of non-associated gas production have been about 83% of total production. If this 83% factor is used, a total 1982 dry gas production capability of about 20,152 Bcf is implied.[2,3]

The data used in the second method are shown in Table 2. Monthly dry production is published in the *Monthly En-*

FIGURE 1 Annual Gas Produced per Gas Well (MMcf per year)

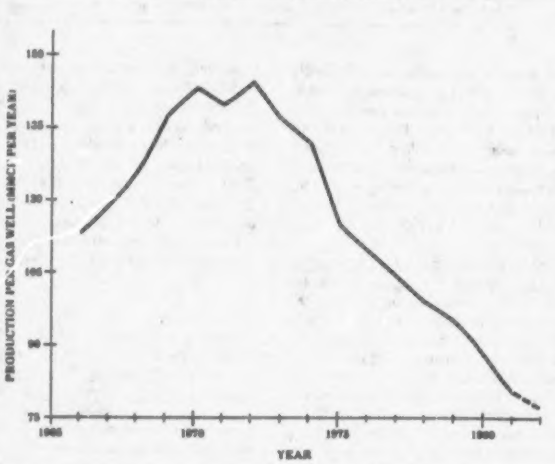

TABLE 2 Demonstrated Production Capability

Year	Month of Peak Daily Production	Indicated Production Capability in Bcf	Actual Production Capability in Bcf
1976	February	19,849	
1977	February	20,883	
1978	February	20,583	
1979	February	20,544	
1980	March	20,923	20,923
1981	January	20,063	20,923
1982	February	19,984	20,923

TABLE 3 * Production and Production Capability 1976-1982 (in Bcf)

Year	Actual Production	Production Capability		Unused Production Capability	
		Method[1]	Method[2]	Method[1]	Method[2]
1976	19,098	19,098	19,849	N/A	751
1977	19,163	19,163	20,883	N/A	1,720
1978	19,122	19,122	20,583	N/A	1,461
1979	19,663	19,663	20,544	N/A	881
1980	19,602	19,602	20,923	N/A	1,321
1981	19,424	19,424	20,063	N/A	639
1982	18,259[1]	20,152	19,984	1,893[2]	2,664[3]

Note: Method 1 assumes that from 1976 to 1981 there was no unused production capability.

[1] Estimates using EIA *Monthly Energy Review* data through August 1982.

[2] If the 1980 and 1981 data are excluded because these years included some excess production capability, a non-associated gas production per well of 79.8 MMcf per year results (as described in Footnote 2, Table 1); the total unused production capability for this case would be 2,626 Bcf. This is a multi-year estimate of unused production capability, in contrast to the 1,893 Bcf estimate which is the incremental increase in unused production capacity in 1982 as compared to 1981.

[3] This estimate is derived using the 1980 production capability of 20,923 Bcf and the 1982 estimated production of 18,259 Bcf.

ergy Review The month with the highest daily rate of production is used to compute the maximum annual capability for each year. Given that this measurement is weather- and demand-sensitive, and that there is no trend in production capability between 1976-82, it was assumed the highest level recorded over the period was the 1982 "capability."

Table 3 shows the actual production and production capability estimates from 1976 to 1981. Extrapolation of the Energy Information Administration's *Monthly Energy Review* gas production data in 1982 (through August) to estimate an annual production of 18,259 Bcf is indicated. The difference between the two capability estimates (20,152 Bcf for Method 1 and 20,923 for Method 2) and the 18,259 Bcf of anticipated production are 1,893 Bcf and 2,664 Bcf respectively. It should be noted that the 1,893 Bcf/year bubble represents the 1982 increase from 1981. Using this methodology on a multi-year basis, we estimated a 699 Bcf bubble in 1981 and an aggregate bubble of 2,592 Bcf in 1982. These "bubble" estimates exclude the nearly 1 Tcf of Canadian gas under contract and not being taken. These levels are at least representative of the current national unused gas production capability.

Conclusions

Natural gas production in 1982 will be lower because of limited demand for natural gas. Estimates of production capability are highly susceptible to error; however, two estimating methodologies have been developed which indicate that the production capability for 1982 will be somewhat more than 20,000 Bcf.

When this capability is compared to a probable production level of about 18,259 Bcf, an unused production capability of about 1.9 to 2.7 Tcf is indicated. The major part of this unused production capability exists because gas demand is limited by use restrictions and national economic problems. Full utilization of this capability is not likely to occur with current natural gas consumption patterns. ☐

ARTICLE #3

Public Utilities
FORTNIGHTLY

Fuel Switching by Industrial and Electric Utility Gas Users: An Overlooked National Issue

By HENRY R. LINDEN and RICHARD H. HILT

Reprinted from
PUBLIC UTILITIES FORTNIGHTLY
Arlington, Va.
1982

Fuel Switching by Industrial and Electric Utility Gas Users: An Overlooked National Issue

By HENRY R. LINDEN and RICHARD H. HILT

One of the most important national energy policy issues centers on the future role of natural gas in the industrial and electric utility markets. Natural gas currently supplies more than one-third of the energy used by the industrial sector—the energy equivalent of over 4 million barrels of oil per day. In addition, it provides 15 per cent of the primary energy used for central power generation, equivalent to nearly 2 million barrels of oil per day. Altogether, industrial and electric utility use constitutes 60 per cent of the total gas market, which makes it imperative to factor the potential impacts of interfuel competition on these market segments into gas acquisition and marketing strategies.

The strong position of gas in the industrial and electric utility markets has evolved under conditions of price regulation which have kept gas cheaper than other fuel sources. Numerous proposals by key federal officials, members of Congress, and influential industry groups indicate a strong desire to modify the Natural Gas Policy Act in order to accelerate the scheduled deregulation of natural gas at the wellhead. Under these proposed deregulation paths, gas prices will, at the very least, increase at a faster rate than the prices of competing fuel sources.

Insofar as interfuel competition is concerned, the industrial and electric utility sectors will approximate a free market. As gas prices rise through deregulation, and especially if they rise significantly in comparison to petroleum prices as now seems possible, the early marketplace responses which will determine the initial "market-clearing" price for gas will probably be the actions of those gas users who could potentially switch fuel in the industrial and electric utility markets. Although rising prices will also have a similar effect on the competitive position of gas in the high-priority residential and commercial markets, these markets are less flexible in their ability to react quickly to price increases through fuel switching.

Thus, in projecting the likely point of gas supply and demand balance, the potential for future displacement of gas with alternative energy sources in the industrial and electric utility markets creates a great deal of uncertainty. The probability of such a displacement is quite high under several possible scenarios. One such scenario would be a gas deregulation path causing an excessive rise in wellhead prices, even if such a rise above market-clearing levels is relatively short-term. The NGPA without modification to defuse the post-1984

Natural gas has evolved a strong position in the industrial and electric utility markets under conditions of price regulation which has kept gas cheaper than other fuels. That policy is gradually being abandoned by the federal government. As a consequence, gas prices are likely to increase at a faster rate than the prices of competing fuel sources. The potential for future displacement of gas by alternative energy sources in industrial and electric utility markets creates much uncertainty for the gas industry. The Gas Research Institute recently undertook an assessment of the potential for fuel switching in these markets by investigating the various demand levels for alternative energy sources which could occur under different foreseeable sets of impacting circumstances (scenarios). This article describes the results of the GRI study, which indicate, briefly, that there is far more potential for fuel switching than has been generally recognized.

impact of indefinite price escalator clauses in existing contracts, or an accelerated deregulation scheme without an appropriate cap to keep gas competitive with oil at the burner tip, could result in such a scenario.

Another possibility would be a low world oil price scenario which would be consistent with the assumption of a continuing and perhaps even growing overhang of world oil productive capacity for at least the remainder of the decade. This could lead to efforts by low-cost oil producers to compete with industrial and electric utility uses of gas on a worldwide basis by aggressively marketing residual fuel oil. Such a strategy would also be attractive to many of the world's refiners now suffering from weak product demand and poor prospects for returning to the high operating rates of the 1970s. Naturally, such a development would take time, and until corresponding supply and product slate adjustments for domestic and foreign sources could be accomplished, reliable contracts for residual oil may not be available to all who desire to switch from gas.

In the case of a high world oil price scenario, consistent with such assumptions as success of the Organization of Petroleum Exporting Countries in protecting cartel pricing through effective control of production, another Mideast upheaval, or a variety of other events that could upset the existing favorable supply-demand balance, different factors would influence the potential for industrial and electric utility gas market losses to oil. For example, the probability of such losses even at high world oil price levels would be enhanced by the greater likelihood of excessive natural gas price increases as gas producers attempt to take advantage of tight hydrocarbon supplies while refiners retain their flexibility to discount residual fuel oil prices below crude oil acquisition costs to whatever level they find economically attractive in the context of overall product slate profitability.

In the light of rising U. S. gas prices and steady or falling oil prices, the Gas Research Institute recently undertook a study designed to assess the potential for fuel switching in the industrial and electric utility markets by investigating the various demand levels for alternative energy sources which could occur in these markets. The study examines the total capability of existing industrial and electric utility gas users to switch to other fuels in three separate time frames. The results of the study, which indicate that there is far more potential for fuel switching than has been generally recognized, constitute the remainder of this article.

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The analysis is based upon sensitivity studies of energy demand in the industrial and electric utility sectors which were performed during the development of the 1981 "*GRI Baseline Projection of U. S. Energy Supply and Demand*" (referred to in this article as the 1981 *GRI Baseline Projection*).[1]

In industry and electric utilities, the decision makers who choose among competitive fuels are generally well informed about market conditions and outlook. Compared to the multitude of individuals who comprise the commercial and residential energy markets, these decision makers are more capable of implementing business and financial decisions indicated by their analyses.

In this study, the total capability of existing industrial and electric utility gas users to switch to other fuel alternatives is considered in three situations:

1) Immediate — within six months of a price signal.
2) Short term — within one year of a price signal, allowing sufficient time to make relatively minor equipment modifications.
3) Long term — within four years of a price signal, allowing the replacement of capital equipment for existing and projected new energy demands both by converting to alternative fuels and by implementing conservation measures.

In each case, for this analysis the price signal is assumed to occur on January 1, 1982.

The first situation (immediate-term fuel switching) is tested with gas prices assumed at two levels: (1) equivalent at the burner tip to the price of low-sulfur residual oil and (2) equivalent to the price of distillate oil. For the other two situations (short-term and long-term fuel switching), the effects of three levels of gas prices relative to petroleum product prices are tested: Gas prices are assumed to be equivalent at the burner tip to the price of (1) low-sulfur residual oil, (2) distillate oil, and (3) 110 per cent of the price of distillate oil. Price projections for petroleum products used for computations in this analysis are taken from those used in developing the 1981 *GRI Baseline Projection*, and are broken down into regional prices for industry and electric utilities. For residual oil, the range in regional prices is about $6 to $6.25 per million Btu at the end of 1982 and about $6.50 to $6.75 per million Btu at the end of 1985. For distillate, the range is $7 to $7.25 per million Btu at the end of 1982 and $7.75 to $8 per million Btu at the end of 1985. Because prices developed for the 1981 *GRI Baseline Projection* were projected from a 1980 base year, they tend to be higher than the prices experienced in the first half of 1982. However, the conclusions about market reactions are primarily a matter of relative prices and would be substantially the same if current oil prices were used.

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[1] 1981 "*GRI Baseline Projection of U. S. Energy Supply and Demand 1980-2000*," by T. Woods, R. Hilt, J. Rasmussen, and D. Dreyfus, Gas Research Insights, Gas Research Institute, Chicago, published January, 1982.

Limiting Assumptions

This analysis explores the maximum potential for existing gas users to convert to alternative fuels under the conditions postulated. The constraints imposed by the physical limitations of equipment capabilities and the lead times necessary to retrofit or replace capital equipment are included in the analysis, but no restrictions upon the availability of the alternative fuels are assumed. Furthermore, the additional demand for alternative fuels created by conversions is assumed not to result in price increases for these alternatives during the term of the analysis. Thus, the findings represent what is essentially a "worst case" situation.

Immediate-term Fuel Switching

A major increase in the price of gas which would bring its burner-tip price up to or above that of competing petroleum products can be expected to result in immediate fuel switching actions. In this analysis immediate fuel switching is defined as that which could take place within six months of the gas price increase.

The determinants of the amount of immediate-term fuel switching are the relative prices of gas and alternative fuels and the capacity of dual-fuel capacity equipment currently installed. The market share of the industrial sector using gas is taken from the 1981 *GRI Baseline Projection*. An estimate of the proportions of this use by those with the capability to switch to residual fuel oil, distillate, or liquefied petroleum gas is based on data from the Bureau of the Census' Survey of Manufacturers for 1978, the latest complete data available.[2]

Gas use in industrial boilers and process heaters comprises 80 per cent of current industrial gas demand. The remaining uses for gas (feedstock, plant, and lease gas) are less sensitive to price increases.

In industrial boilers, the total population of gas-using equipment currently consumes three quads of gas. The gas-burning boilers which technically could convert to residual oil account for 2.5 quads of this amount. The remaining boilers technically could convert to distillate or liquefied petroleum gas and account for the remaining 0.5 quad of current gas consumption.

In industrial process heaters, the current total population of gas-using equipment is estimated to consume 3.7 quads. Of this amount, 0.8 quad technically could be replaced by residual oil and 2.9 quads by distillate oil.

According to the Bureau of the Census' 1978 Survey of Manufacturers, in the immediate term 44 per cent of gas-using equipment could switch to residual oil and 63 per cent could switch to distillate and liquefied petroleum gas. (Percentages are nonadditive because populations overlap.) These percentages applied to the populations of process heaters and boilers set forth above provide estimates of the amounts of gas demand which could be replaced in the immediate term if gas prices are equated at the burner tip with the prices of low-sulfur residual oil and distillate. These amount are 1.5 quads at prices equivalent to low-sulfur residual oil and 3.6 quads at prices equivalent to distillate.

In electric utilities the major factor affecting immediate-term fuel switching is the quantity of dual-fuel capacity in place. In steam-electric units that can burn either residual oil or gas, the two fuels compete essentially on a cost per Btu basis. Natural gas, because its flame is less radiant, is slightly less efficient than residual oil in steam-electric power plants. Gas recovers part of this disadvantage, however, with lower, nonfuel operating costs. Generally, in electric utilities, residual fuel oil can sell at a ten-cent to 20-cent per million Btu premium over gas and remain competitive. The precise economics of switching between gas and oil is dependent upon the design and operating characteristics of individual power plants.

There are, however, noneconomic factors which account for the existing division of electric utility market shares between oil and gas. The average delivered price of all residual oil burned at electric power plants in 1980 was $4.28 per million Btu with average prices ranging from $3.45 per million Btu for high-sulfur residual oil (2 to 3 per cent S) to $4.99 per million Btu for low-sulfur residual oil (0.3 per cent S). On the other hand, the national average delivered price of natural gas to electric utilities in 1980 was $2.12 per million Btu, with average prices over $3 per million Btu in just five states —Pennsylvania ($3.67), Idaho ($3.76), California ($3.26), Oregon ($4.34), and Washington ($3.47). On economic grounds alone, gas should have been used in dual-fired (gas and residual oil) steam units for all but a very small portion of the 3.4 quads of energy demand in these units in 1980. In fact only 2.4 quads of gas were used. The one quad of residual oil used in those units instead of gas was largely the result of noneconomic forces, such as concerns about gas availability and contractual constraints. However, this analysis of fuel

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[2] "1978 *Annual Survey of Manufacturers*," U. S. Department of Commerce, Bureau of the Census, Government Printing Office, Washington, D. C., 1979, pp. 4-173.

switching assumes that over the terms of this analysis dual-fuel capacity in steam-electric power plants would be converted to an alternative fuel if indicated by the economics.

For 1982, electric utilities are expected to consume a total of 3.7 quads of gas. In the immediate term, electric utilities are projected to be capable of replacing an estimated 2.3 quads of gas at low-sulfur residual oil prices and 2.7 quads at distillate prices.

Table 1 summarizes the total fuel switching which could occur in the immediate term in the industrial and electric utility sectors.

TABLE 1

IMMEDIATE-TERM FUEL SWITCHING
(QUADS OF GAS REPLACED AT VARIOUS BURNER-TIP GAS PRICES)

	Equivalent of Low-sulfur Residual Prices	*Equivalent of Distillate Prices*
Industry	1.5	3.6
Electric Utilities	2.3	2.7
Total	3.8	6.3

It is important to emphasize the assumption that the increased demand for alternative fuels would not create market distortions or supply shortages. Substitution of 3.8 quads of gas at prices equivalent to the price of low-sulfur residual oil, for example, would produce an additional demand of 1.7 million barrels per day for residual oil. Because the current total demand for residual oil is about 2 million barrels per day, the additional demand could actually have a substantial impact on residual oil prices in the marketplace.

Short-term Fuel Switching Including Retrofitting

In the previous discussion of the immediate term, fuel switching is constrained to that which can be achieved with the physical capabilities of existing equipment. If higher gas prices occur and continue to persist for a somewhat longer period, additional fuel switching capability can be created by modifications of equipment. The short-term analysis considers fuel switching which technically could occur within one year of the initial increase of gas prices, if some of the existing equipment were retrofitted.

As in the immediate term, a major factor affecting the amount of industrial sector fuel switching in the short term is the dual-fuel capacity of existing equipment. Because of the additional six months of time involved, however, the industrial sector has sufficient opportunity to retrofit existing equipment that is currently only capable of using gas. Thus, the quantity of gas which could be replaced depends on the combination of dual-fuel capacity found in the immediate-term plus the amount of retrofitting of in-place equipment that is economical during the year.

The analytical framework which is used in estimating fuel switching in the industrial sector for the remainder of this analysis is the industrial fuel choice analysis model, developed by Energy and Environmental Analysis, Inc. (EEA).

In the short term, the total gas market for industrial boilers and process heaters, as estimated in the 1981 *GRI Baseline Projection*, is 6.5 quads. Boilers and process heaters which have technical capability to switch within one year use an estimated 6.1 quads. The 0.4 quad difference between these figures is attributed to process heaters which cannot be converted to alternative fuels because of technical limitations.

In electric utilities, no additional ability to switch from gas to alternative fuels is provided by the additional six months of time beyond the immediate time frame. Unlike the industrial sector, electric utilities are constrained in retrofitting existing equipment because of the regulatory environment in which they operate. The total gas use in electric utilities by the end of 1982, as developed in the 1981 *GRI Baseline Projection* is 3.7 quads, of which 2.8 quads could be switched to alternative fuels. The remaining 0.9 quad cannot be displaced by alternative fuels because of technical constraints.

As shown in Table 2, depending upon the gas price assumption, between 40 per cent and 70 per cent of the total electric utility and industrial market for 12.3 quads of natural gas would be lost. Table 2 shows the range of gas switching for the industrial and electric utility markets for the three burner-tip gas prices evaluated.

TABLE 2

SHORT-TERM FUEL SWITCHING
(QUADS OF GAS REPLACED AT VARIOUS BURNER-TIP GAS PRICES)

	Equivalent of Low-sulfur Residual Prices	*Equivalent of Distillate Prices*	*Equivalent of 110 Per Cent Distillate Prices*
Industrial			
Boilers	2.1	2.6	2.6
Process Heaters	0.8	3.3	3.5
Subtotal	2.9	5.9	6.1
Electric Utilities	2.3	2.7	2.8
Total	5.2	8.6	8.9

Long-term Fuel Switching

The long-term analysis (four years) involves a more complex combination of factors affecting gas markets. Capital substitution becomes increasingly possible, especially in the electric utility sector. The longer time frame allows some additional displacement of gas by oil; furthermore, because of the longer time period, the potential exists to substitute coal, nuclear energy, and conservation for both oil and gas. The 1981 *GRI Baseline Projection* assumes that the scheduled completion date of coal and nuclear units is delayed because of financial constraints and lower growth in electricity demands. This analysis of fuel switching assumes that higher gas prices will cause electric utilities to begin to reduce the period of delay in completing coal and nuclear units, resulting in completion which approaches originally scheduled dates. The quantity of gas which could be replaced therefore depends on a combination of the amount of dual-fuel capacity, retrofitting of existing equipment, and substitution of new capital equipment.

The total industrial market for gas is essentially the same at the end of four years as after one year. In the 1981 *GRI Baseline Projection*, demand for gas in industrial boilers and process heaters is estimated to be 6.5 quads. As in the short term, 0.4 quad of gas in process heaters cannot be converted to alternative fuels because of technical constraints. Thus, 6.1 quads of gas are consumed in boilers and process heaters which have the technical capability to switch. By the time gas prices rise to the equivalent at the burner tip of 110 per cent of distillate, new capital equipment is substituted which displaces 0.5 quad of gas with coal and conservation. The remaining 5.6 quads of gas are displaced by oil.

Analysis of long-term fuel switching in electric utilities involves the estimation of the number of units which would be converted to burn other fuels and the projection of the number of new units which would be completed. Because the time frame is four years, this analysis must consider not only the quantities of gas replaceable by petroleum in dual-fuel equipment, but also, because revisions or rescheduling of ongoing construction programs are possible, the quantities of gas replaceable by other energy sources or by conservation.

Conversions in electric utilities were analyzed using a process model developed by EEA. Over a four-year time frame it would be possible for utilities to convert gas-only or gas-distillate steam units to burn residual oil. In developing the 1981 *GRI Baseline Projection*, the costs associated with fuel conversions in electric utilities were analyzed. The cost of converting a 250-megawatt gas-only unit, including a 90-day supply of oil, would be about $18.5 million. This includes $3.5 million for storage tanks (figured at $10 per barrel of capacity); $3 million for soot blowers and equipment to handle and burn residual oil; and $12 million for fuel stockpile (at $34 per barrel). With a 40 per cent capacity utilization factor and a 15 per cent interest rate, fuel conversion costs 35 cents per million Btu for an investment amortized over a ten-year period. To this cost, five cents per million Btu must be added for higher operating and maintenance costs and ten to 20 cents per million Btu subtracted for efficiency gains from using residual oil. Thus, conversion of a gas-only unit to residual oil would be economical only if gas is expected to remain at least 20 to 30 cents per million Btu more costly than residual oil.

The maximum use of gas in 1985 by electric utilities is estimated from the 1981 *GRI Baseline Projection* to be 3.5 quads. There is little difference in total amounts of gas replaced in one-year and four-year periods. The composition of the alternative fuels which replace the gas, however, does change. By the time gas prices rise to the equivalent of 110 per cent of distillate, a total long-term displacement of 2.9 quads occurs, of which 2.5 quads are displaced by increased oil use and 0.4 quad by coal and nuclear energy, reflecting changes in scheduled completion dates.

In the long term, the estimate of the total quantity of gas replaced ranges from about 50 per cent to 75 per cent of total gas demand for electric utilities and industry, depending upon the assumptions for the price of gas. Table 3 presents a breakdown of the quantities of gas replaced.

TABLE 3

LONG-TERM FUEL SWITCHING
(QUADS OF GAS REPLACED AT VARIOUS BURNER-TIP GAS PRICES)

	Equivalent of Low-sulfur Residual Prices	*Equivalent of Distillate Prices*	*Equivalent of 110 Per Cent Distillate Prices*
Industrial			
Boilers	2.4	2.6	2.6
Process Heaters	1.0	3.3	3.5
Subtotal	3.4	5.9	6.1
Electric Utilities	2.5	2.8	2.9
Total	5.9	8.7	9.0

Implications of the Study

The findings contained in this analysis have important implications for the gas industry. The industrial and electric utility markets are capable of quickly switching fuels and will be first to respond to increasing gas prices. The impact on the gas market of fuel switching in these sectors is summarized in Table 4. Almost half of the entire market for gas could switch to alternative fuels in a rather short period of time if gas prices at the burner tip rise to prices equivalent to distillate oil.

TABLE 4
PORTION OF GAS MARKET LOST TO FUEL SWITCHING
(GAS REPLACED IN QUADS AND AS PER CENT OF TOTAL GAS MARKET*)

	Gas Price Equivalent To Low-sulfur Residual Oil Prices		*Gas Price Equivalent To Distillate Prices*		*Gas Price Equivalent to 110 Per Cent Distillate Prices*	
	Quads	*Per Cent*	*Quads*	*Per Cent*	*Quads*	*Per Cent*
Immediate Term	3.8	19	6.3	31	—	—
Short Term	5.2	21	8.6	42	8.9	43
Long Term	5.9	28	8.7	42	9.0	43

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*In each instance the amount of potential fuel switching is converted to a percentage of the total national gas market for all sectors projected at the end of each time period.

This study assumes that supplies of alternative energy sources would be adequate to accommodate the amount of increased demand generated by fuel switching. It also assumes that neither gas prices nor the prices of such

ARTICLE 3 continued

alternatives would be altered during the periods used in the analysis as a result of the changes in demand. Some probable responses of energy markets to these fuel switching actions, however, can be deduced from the study. They are:

- The response of the alternative fuels market to higher gas prices.
- The response of gas markets to higher gas prices.
- The potential for recovery of gas markets lost to fuel switching.

The actual amount of fuel switching which will occur with increased gas prices will depend on the supply and price of alternative fuels. If supplies of oil are adequate and gas prices rise to low-sulfur residual oil or distillate prices and remain there for a substantial period (more than a year), while prices of alternatives remain stable, then the gas industry would lose between 40 and 70 per cent of its industrial and electric utility market. It is unlikely, however, that this "worst case" situation would occur without some compensating market responses. It is more probable that the sudden increase in demand for alternative fuels, particularly petroleum products, would exceed the capabilities of the system to provide immediate, reliable supplies. Furthermore, the demand would probably elicit increases in the price of alternatives. In the longer term, the reductions in gas demand because of initial fuel switching could also result in a reduction in gas prices. Taken together, these effects could mitigate the total market loss for gas.

The results of the analysis indicate, for example, that the current total demand for residual oil would more than double to replace the 5.2 to 5.9 quads of lost gas demand when gas prices rise to the equivalent of low-sulfur residual oil. Until corresponding supply adjustments from both domestic and foreign sources could be accomplished, reliable contracts for residual oil would not be available to all who desired to switch from gas. In all probability, residual oil prices would rise significantly and extraordinary conservation, and even decreases in industrial production levels, might result from the increased prices for both fuels. Quite probably, some portion of these responses would persist, creating a generally smaller energy demand and generally higher energy prices.

Higher gas prices almost certainly would result in an increase in dual-fuel capability as existing users retrofit their equipment and new users take steps to decrease their vulnerability to future fuel price changes. The effect would be to create a more volatile, competitive market in which relatively small variations in oil and gas prices would result in large swings between fuels. Furthermore, differences among the relative local price advantages of various fuels could increase the regional dominance of one fuel over another.

Despite the likelihood of these several responses and the limits that they may impose upon the total market loss which gas would incur, escalations in gas prices could result in very substantial amounts of fuel switching away from gas before countervailing forces become effective. From recent experience we know the reaction of gas markets to higher gas prices is to increase exploration and development activities. Higher gas prices, therefore, could result in decreased demand along with increased supply. This in turn would drive gas prices back down in order to clear the markets of the excess supply, assuming that provisions in gas contracts would not inhibit market responses. The possibility of large swings in prices and demands could make the planning of gas production difficult.

It is reasonable to expect that given an escalation in gas prices, a significant amount of fuel switching from gas to oil would occur. Even with a subsequent reduction in gas prices, coal, nuclear energy, conservation, and some irreversible switching to oil would permanently reduce the gas market by a significant amount over the long term. In summary, burner-tip prices for gas exceeding those of low-sulfur residual oil would change the competitive structure of electric utility and industrial markets for oil and gas. The nature of these markets would become increasingly more volatile. One result of increased gas prices, even for a relatively short period of time, would be an increase in dual-fuel capacity. Switching between fuels thereafter to a great extent would be based upon relative prices. Under volatile, highly price-sensitive market conditions, relatively small price differences could result in major market share shifts among competitive fuels.

The development of advanced gas supply and utilization technologies could significantly improve the competitive position of gas in this situation. Major additions to supply from sources such as tight formations appear to be achievable at low marginal costs. Equally important, the physical and chemical properties of methane make it much more susceptible than competing fuels to improvements in the efficiency of end-use technologies. Taken together, the results of a coordinated gas research and development program could favorably affect the price elasticity of gas in the industrial and electric utility markets and stem the potentially severe market erosion which could otherwise occur in the event of a prolonged increase in gas prices above current market-clearing levels.

ARTICLE #4

A Statistical Analysis of Bidding Trends for Decontrolled Natural Gas Under the NGPA

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In Brief

This analysis examines recent gas purchases of Section 107 gas (principally deep, decontrolled gas). The analysis concludes that those interstate pipeline systems holding large gas cushions (ie., controlled gas at relatively low prices) have been less aggressive in the purchases of decontrolled gas. The analysis also found a strong inverse correlation between interstate pipelines with high reserve to production (R/P) and Section 107 gas purchases.

This article reproduces in its entirety, A.G.A.'s recent analysis entitled: "A Statistical Analysis of Bidding Trends for Decontrolled Natural Gas Under the NGPA," (Energy Analysis 1982-5, March 19, 1982).

Background

One of the two key assumptions underpinning any analysis of alternative wellhead gas decontrol policies is the impact controlled gas has on the bidding behavior of pipelines for decontrolled gas. The other key assumption involves "indefinite" price escalator clauses in two-thirds of all gas purchase contracts. These clauses, which would be triggered by decontrol, would force large volumes of gas above free market price levels. This latter issue is a contract (non-economic) problem and must be addressed through legislation—under present law the necessary regulatory authority to remedy this problem may not exist. The former issue—how the gas cushion (i.e., controlled, low-priced gas inventory) will impact pipeline bidding for new decontrolled gas—is central to forecasting average gas prices and volumes under "partial" wellhead decontrol as scheduled for 1985 under existing law.

The Natural Gas Policy Act of 1978 (NGPA) decontrolled certain limited quantities of "high cost" gas in 1979 (e.g. deep gas below 15,000 feet) and will decontrol most new gas (i.e., post-1976 gas) in 1985. This type of decontrol has been labeled "partial" decontrol because it does not decontrol old flowing gas volumes.

The purpose of this analysis is to examine pipeline bidding behavior to date for Section 107 gas (principally decontrolled deep gas) to determine whether pipelines are bidding for this high-priced gas in order to rebuild their reserve-to-production ratios (R/P), or because of the size of their respective gas cushions. Extensive data on interstate pipeline supplies of Section 107 gas, making this statistical analysis possible, was published by the U.S. Department of Energy, Energy Information Administration, in a report entitled, "An Analysis of the Natural Gas Policy Act and Several Alternatives."[1]

Executive Summary

The following conclusions are based on statistical analysis of data contained in the draft EIA report, cited above.

- Interstate gas pipelines holding large gas cushions have been relatively reluctant to bid aggressively for deep gas which is decontrolled under Section 107 of the NGPA. To illustrate, there is a significant (99% confidence level) *inverse* correlation between the size of a pipeline's gas cushion and the price it pays for Section 107 gas.

There is also a positive correlation (90% confidence level), between the price of a pipeline's gas cushion and the percentage of Section 107 gas in its supply mix (i.e. pipelines with low-priced cushions have been reluctant to purchase Section 107 gas).

- Likewise, a strong inverse correlation exists (95% confidence level) between a pipeline's reserves-to-production ratio (R/P) and its willingness to purchase Section 107 gas (i.e., pipelines with high R/P ratios have generally purchased

Source: AGA, Gas Energy Review, 5/82

less Section 107 gas at lower prices). * This would indicate that Section 107 gas purchases are being made to strengthen long-term gas reserve positions.

The strong inverse correlation between Section 107 gas purchases and both the size of pipelines' gas cushions and their R/P ratios would appear to contradict the theory that pipelines with large gas cushions remaining after most gas is decontrolled in 1985 under the NGPA, would rush into the market in 1985 to bid-up the price of decontrolled gas above a long-run competitive market level, or bid away supply from companies with smaller gas cushions. These correlations suggest that pipeline gas purchases may be based at least in part, on *long-term* gas requirements — not just on short-term market conditions.

Discussion of Results

Table 1 illustrates the relationship between a pipeline's willingness to purchase Section 107 gas and the size of it's cushion (all currently price controlled gas). As the table clearly illustrates, companies with large gas cushions have been reluctant to bid aggressively for Section 107 gas. Companies whose willingness to purchase Section 107 gas was categorized as "High," had an average of "small" gas cushions. Companies whose Section 107 bidding was categorized as "Medium," generally had "average-sized" gas cushions; while companies with a "Low" rating for Section 107 gas purchases had an average of "large" gas cushions. The size of a pipeline's gas cushion (pre-1977 "old" gas and post-1977 price-controlled "new" gas) was calculated by multiplying the percentage of a company's price-controlled gas supplies by the reciprocal of the average price paid for these supplies. The rationale behind this calculation is set forth in the Methodology section.

Table 2 shows the relationship between the willingness of a pipeline to purchase Section 107 gas and its R/P ratio. This table illustrates that companies with relatively large R/P ratios are less aggressive in their bidding for Section 107 gas. The results in this table support the theory that Section 107 bidding to date has been characterized by interstate pipelines attempting to rebuild weakened reserve positions — the result of pre-NGPA Federal regulation of wellhead gas prices at artificially low levels.[3]

Based on the published EIA data, the following correlations exist (with an indication given of the level of confidence with which each statement can be made):

Very Strong Correlation — 99% confidence level that a correlation exists

1. The higher the percentage of non-Section 107 gas *volumes* (both "old," pre-1977 and "new" post-1977 gas) in a pipeline's supply mix, the lower the *price* paid for Section 107 gas.
2. The higher a pipeline's average price for "new" gas, the higher its average price for Section 107 gas.

Strong Correlation — 95% confidence level that correlation exists

1. The higher a pipeline's R/P ratio (excluding reserves attributable to LNG imports), the lower its average purchase price for Section 107 gas.
2. The higher a pipeline's R/P ratio (excluding LNG), the lower its willingness to buy Section 107 gas.

Medium Correlation — 90% confidence level that a correlation exists

1. The higher the R/P ratio (excluding reserves attributable to LNG imports), the lower the quantity of Section 107 gas purchased.
2. The higher the price of non-Section 107 gas, the greater the percent of Section 107 gas by volume in pipelines' gas purchases.
3. The higher the percentage of "old" gas in a pipeline's supply mix, the lower the percentage of Section 107 gas.

TABLE 1 **Relationship Between "Gas Cushion" and Section 107 Gas Purchases**

Willingness to Purchase Section 107 gas		*Gas Cushion*	
Category	*Index*[1]	*Average Price of Cushion Gas*[2] *($/MMBtu)*	*Cushion Index*[3]
High	81	$1.98	46
Medium	32	$1.75	54
Low	5	$1.69	60
Average	37	$1.80	54

[1] Index calculated by multiplying the percentage of pipeline purchases for 1981 that are Section 107 gas times the average price paid by that pipeline for Section 107 gas.

[2] Average pipeline gas acquisition cost excluding Section 107 is one measure of gas cushion.

[3] Index calculated by multiplying percentage of gas purchases that are "cushion gas" times the reciprocal of the price paid for this gas.

TABLE 2 Relationship of Reserve Production (R/P) Ratio to Section 107 Purchases

Willingness to Buy S. 107 gas Index[1]	*Average 1979 R/P Ratio*[2]	*Range 1979 R/P Ratio*
High	7.3	4.8-10.0
Medium	8.9	3.6-13.5
Low	10.4	7.7-16.7
Average for entire sample	8.9	3.6-16.7

---

[1] Calculated by multiplying pipeline's average purchase price for Section 107 gas times the percentage of Section 107 gas in its supply mix. Source: *An Analysis of the Natural Gas Policy Act and Several Alternatives* (December 1981, Energy Information Administration, Washington, D.C.), p. 66.

[2] Excludes non-North American reserves. Source: *Gas Supplies of Interstate Natural Gas Pipeline Companies—1979* (June 1981, Energy Information Administration, Washington, D.C.).

TABLE 3 Statistical Correlations Between Section 107 Gas Purchases, Gas Cushion, and R/P Ratio[1]

	Average Price of Section 107 Gas	*Percentage Section 107 Gas in Supply Mix*	*Willingness to Buy Section 107 Gas Index*
Price— "new" controlled (Post-1977) gas	99% confidence positive correlation	Inconclusive	90% confidence positive correlation
Percentage— "new" controlled gas	95% confidence inverse correlation	Inconclusive	Inconclusive
Price—"old" gas (pre-1977)	Inconclusive	Inconclusive	Inconclusive
Percentage—"old" gas	Inconclusive	95% confidence inverse correlation	90% confidence inverse correlation
Price—all cushion gas[2]	Inconclusive	90% confidence positive correlation	90% confidence positive correlation
Percentage—all cushion gas[2]	99% confidence inverse correlation	Unity	99% confidence inverse correlation
Pipeline R/P ratios[3]	95% confidence inverse correlation	90% confidence inverse correlation	95% confidence inverse correlation

---

[1] The confidence level shown in this Table indicates the probability that a correlation exists between the variables shown.

[2] "All Gas Cushion" includes gas supplies subject to price controls, both "new" post-1977 gas and "old" pre-1977 gas.

[3] R/P ratio (reserve to production ratio) is a measure of the North American reserves dedicated to a particular pipeline divided by that pipeline's current gas sales.

ARTICLE #5

Mexican Gas Supplies to the United States

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and

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Background

On Oct. 19, 1979, a gas purchase agreement was made between Border Gas[1] and Petroleos Mexicanos (PEMEX)[2]. The agreement called for 300 MMcf of Mexican gas to be delivered per day to an interconnection between PEMEX and Texas Eastern Transmission Corp. near Hidalgo, Texas. The agreement became effective Jan. 1, 1980, although deliveries were delayed until Jan. 15, 1980, at which time the interconnections were made. The initial price was $3.625 per MMBtu and according to the agreement, the price could be adjusted quarterly in accordance with a composite index of crude oil prices.

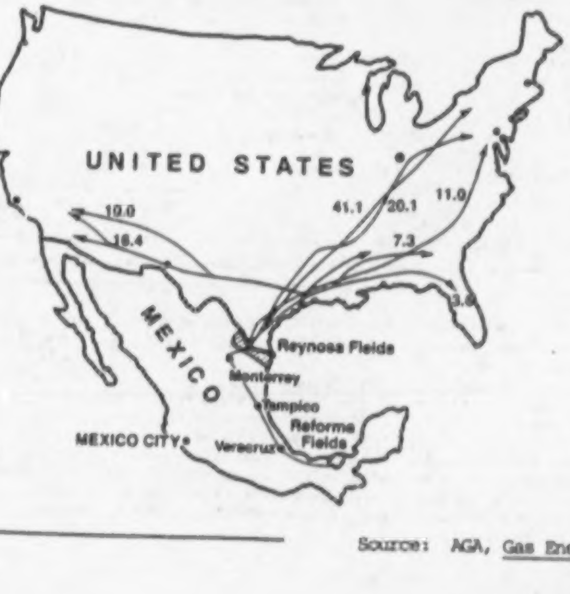
Current Status

Table 1 lists the six member corporations of Border Gas Inc. along with the 1981 import volumes. Figure 1 illustrates the Mexican gas pipeline routes from producing fields, plus the volumes and patterns of distribution of the maximum level of imports. Texas Eastern Transmission Corp. transports the imported gas to existing interconnections within Texas for Tennessee Gas Pipeline Co., Transcontinental Gas Pipe Line Corp., and Florida Gas Transmission Co. Southern Natural Gas Co. receives its share through interconnections with Florida Gas in Texas and Louisiana. Valero Energy Corp. also receives gas from Texas Eastern for transmission to El Paso Natural Gas Co. and Transwestern Pipeline Co. (a subsidiary of Texas Eastern which receives one-third of Texas Eastern's share).

The average price for Mexican natural gas during 1981 was approximately $4.91 per MMBtu. On Jan. 1, 1981, the price for Mexican gas rose from $4.47 to $4.82 per MMBtu, the price allowed by the contract formula. In April 1981, the Economic Regulatory Commission granted a price increase for the Mexican imports to achieve a parity with the price of gas imports from Canada. Since April 1, 1981, Mexican and Canadian gas imports have been $4.94 per MMBtu (See Table 2).

Recently, officials of Border Gas Co. have conducted informal discussions with PEMEX, the Mexican national oil company, with the intent to increase,

FIGURE 1 Maximum Allowable Annual Mexican Gas Imports Transported by Interstate Pipelines* (Bcf per year)



Source: AGA, Gas Energy Review, 5/82

TABLE 1 **Mexican Gas Imports by Company**

Company	*Percentage Ownership of Border Gas*	*States Served*[1]	*Contracted Maximum Daily MMcf*	*Actual 1981 Imports Bcf*	*1980 Sales Bcf*	*Percentage of Mexican Gas to Total Pipeline Sales —1980*
Tennessee Gas Transmission (Tenneco)	37.5	Tennessee West Virginia Pennsylvania New York Massachusetts Kentucky	112.5	39.4	1,112	3.5
Texas Eastern Transmission[2]	27.5	Pennsylvania New Jersey Ohio Louisiana New York	82.5	28.9	931	3.1
El Paso Natural Gas	15.0	California Arizona Texas Nevada New Mexico	45.0	15.7	1,119	1.4
Transcontinental Gas Pipe Line	10.0	New York New Jersey Pennsylvania North Carolina Mississippi Virginia Georgia	30.0	10.5	889	1.2
Southern Natural Gas	6.7	Georgia Alabama South Carolina Louisiana Mississippi	20.1	7.0	597	1.2
Florida Gas Transmission	3.3	Florida	9.9	3.5	183	1.9
	100.0		300.0	105.0	4,831	2.2

---

[1] Includes only states receiving at least 20 Bcf annually from the company and receiving at least 2% of the company's total gas sales. States are listed in order of volume of receipts from each company.

[2] One-third of Texas Eastern's share will be transported by Transwestern Pipeline Co. (a subsidiary of Texas Eastern) for sale in California.

and possibly double, the amount of current gas imports from Mexico. In order to achieve this, Border Gas will need to increase pipeline capacity by building a 115-mile pipeline parallel to the existing pipeline between the border at Hidalgo, Texas, and the pipeline interconnections in Agua Dulce, Texas. At this time, no formal applications to increase the volume of imports have been filed at either the U.S. Federal Energy Regulatory Commission or the Economic Regulatory Administration.

Mexican Gas

Mexico has tremendous reserves of crude oil and natural gas. Proven reserves are estimated to be over 72 billion barrels of oil and gas in oil equivalents. Probable and potential reserves are estimated at over 250 billion barrels. Approximately 27% of proven reserves are gas reserves. This means that 114 Tcf of gas is proven and, if the 27% can be applied to the probable and potential reserve estimates, an additional 395 Tcf is potentially available. This compares to U.S. proven reserves of nearly 200 Tcf in 1980 and additional potential resources of 913 Tcf as of year-ending 1980.

Gas production in Mexico has been increasing rapidly. In the 1960s, produc-

TABLE 2

Mexican Gas Import Price[1] (Dollars per MMBtu)

Price	*Effective Date*
3.625	Jan. 15, 1980
4.47	March 27, 1980
4.82	Jan. 1, 1981
4.94	April 1, 1981

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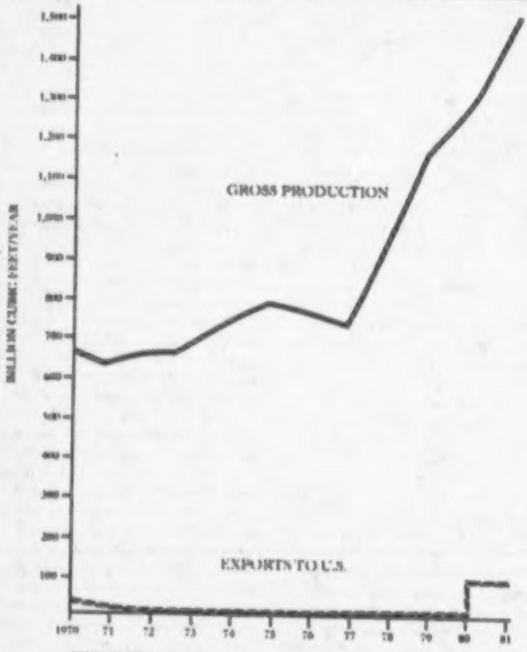
[1] According to the agreement, the price is a function of the average of five crude oil prices: Venezuela Tia Juana Medium (API-26), Saudi Arabia Arab Light (API-34), United Kingdom Forties (API-36), Mexico Isthmus (API-33), and Algeria Saharan Blend (API-44). The average of the crude oil prices (A) is divided by 27.444, which was the base period average oil price. The resultant is multiplied by 3.625 (the base period gas price). The equation is:

$$\frac{A}{27.444} \times 3.625 = \text{new price of imports}$$

The price of Mexican gas imports can be changed at the beginning of each quarter of the year.

FIGURE 2

Mexican Natural Gas Production and Exports to U.S.



SOURCE: *Highlights and Energy Statistics*, Institute of Gas Technology; World Natural Gas, Department of Energy.

tion was about 1,350 MMcf per day. By the 1970s, production was over 2,100 MMcf per day. Current production is estimated to be about 4,100 MMcf per day. Most of the gas produced in Mexico is produced in association with oil. Figure 2 graphically presents the volumes of natural gas production and exports to the United States since 1970.

One factor leading to the export of gas to the United States was the opening of a 48-inch pipeline from the Reforma fields in Tabasco and Chiapas to the industrial city of Monterrey. This allows gas from the Reynosa fields, located near the Texas border, which was previously used in Monterrey, to be delivered to the Texas Eastern interconnection. In effect, Border Gas is receiving gas from Southern Mexico by displacement. ☐

References

[1] *Border Gas Inc., is a Delaware corporation with its principal business in Houston, Texas. It is wholly owned and controlled by six interstate pipeline companies; Tennessee Gas Transmission Co., Texas Eastern Transmission Corp., El Paso Natural Gas Co., Transcontinental Gas Pipe Line Corp., Southern Natural Gas Co., and Florida Gas Transmission Co.*

[2] *Petroleos Mexicanos (PEMEX) is a government owned corporation. It was created on June 7, 1938 to run the oil fields and it is still the only institution legally permitted to explore for, drill or refine petroleum.*

ARTICLE #6

Recent and Potential Substitution of Oil with Gas and Coal in Non-Transportation Uses

by **Michael I. German**
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In Brief

The following article provides a blueprint for using primarily domestic fuels to significantly reduce and eventually eliminate nearly all of our oil imports. It also documents the progress made in the U.S., through 1980, in backing oil out of substitutable stationary uses, and provides preliminary data for the first eight months of 1981. This article reproduces in its entirety A.G.A.'s analysis, entitled: "Recent and Potential Substitution of Oil with Gas and Coal in Non-Transportation Uses," (Energy Analysis 1981-14, December 19, 1981).

Introduction

In 1980, 46% of oil used in the U.S. was consumed for non-transportation purposes—purposes for which natural gas can often substitute (e.g., residential and commercial spaceheating, industrial combustion uses). Since 39% of the oil used in the U.S. in 1980 was imported from foreign sources, it would appear to be in the best interest of the nation to replace in the near-term (0-5 year time frame) large quantities of oil with increased use of natural gas in non-transportation markets.

The purpose of this analysis is to define in overall national terms, that portion of the non-transportation use of oil which can readily be replaced by natural gas and coal, including gas used selectively with coal in large boilers to help meet environmental requirements.

Executive Summary of Major Conclusions

Natural gas, conservation and coal have replaced significant volumes of oil in non-transportation markets over the past two years. In 1980, 500,000 households and at least 13,000 commercial buildings converted from oil to gas.[1] In addition, between 1977 and 1980, oil use in electric power plants declined over 500,000 barrels per day, while gas use in this sector increased by the energy equivalent of 240,000 barrels per day.[2] As the recent reduction in oil imports illustrates, natural gas, coal and conservation have already reduced U.S. oil use. This reduction in oil consumption in the fuel switchable stationary market, caused the short- and long-term oil displacement potential to decline during the year 1980 from 5.5 million barrels per day to 4.5 million barrels per day, reflecting conversions that occurred.

- Out of the 1980 total of 7.4 million barrels per day of crude oil equivalent (mbde) non-transportation use of oil in the U.S., 4.5 mbde were used in combustion applications for which natural gas or gas used selectively with coal, could directly substitute.

61%

- This 4.5 mbde replaceable non-transportation use of oil consists of the following three components: 3.0 mbde of residual and distillate fuel oil consumed by industrial applications and utility power plants, 0.2 mbde of natural gas liquids burned in industry, and 1.3 mbde of fuel oil used for residential and commercial spaceheating and hot water.
- Of the 4.5 mbde substitutable U.S. oil use, 0.9 mbde (or 20%) can be replaced almost immediately (0-1 years) with increased gas use because: (1) additional gas supplies can be made available quickly, (2) the nation's gas transmission and distribution system is presently some 10% to 15% underutilized, and (3) numerous industrial and power plant oil users currently have direct access to gas systems.
- The 3.6 mbde balance can be replaced in the near-term (1-5 years) by gas and coal, including coal with select gas use, permitting time for gas system extentions, new power plant completions and end-users' installations, permitting, and other requirements.

Included in the second category are the nearly one-third of all oil heated homes presently having gas hook-ups for cooking and hot water heating. All of these homes were excluded from the first category of potential conversions because equipment is not presently available to connect 5,000,000 units to gas in one year.

- The remaining 2.9 mbde non-transportation use of oil consists of petrochemical feedstocks, natural gas liquids in remote residential spaceheating applications and asphalt, lubricant oils, and petroleum coke—none of which are directly replaceable by major fuels in the near term.

Discussion of Results

In order to formulate an effective national policy to reduce our nation's vulnerability to an oil supply interruption, it is necessary to ascertain what percentage of our domestic fuel oil consumption can be displaced in the near-term (0-5 year time frame) by alternative fuels (i.e., natural gas and coal).

Table 1 classifies all 1980 non-transportation uses of oil products in the U.S. by sector and by fuel product. This analysis does not address the significant potential for substitution with methane vehicles of petroleum products used in the transportation sector, which consumed 8.8 mbde of the nation's total 1980 oil use of 16.3 mbde. Independent estimates for the potential of methane fuel penetration into the transportation market range from .25 mbde to 1.0 mbde. There are presently between 25,000 and 35,000 methane vehicles on the road in the United States.

Of the 7.4 mbde of petroleum use in the United States shown in Table 1, certain industrial, residential and commercial energy demands cannot quickly be satisfied by natural gas or the joint use of natural gas and coal. However, other oil consumers who presently have access to gas service can physically convert from oil to gas in the very short-term. Therefore, this analysis groups all non-transportation oil consumption into the following categories:

Category One—oil that can almost immediately be displaced by gas. In 1981, A.G.A. conducted a survey of its members to ascertain how much oil they *could* displace in industrial markets with natural gas and, how much gas sales were lost to oil because of demand

Source: AGA, Gas Energy Review, 2/82

TABLE 1

U.S. NON-TRANSPORTATION USE OF OIL PRODUCTS IN 1980
(million barrels per day of crude oil equivalent, mbde)

	Distillate[1]	*Residual Oil*	*LPG/Other*[2]	*Asphalt*	*Total*
Residential	0.9	—	0.2	—	1.1
Commercial	0.2	0.2	0.1	0.5	1.0
Electricity Generation	0.1	1.3	—	—	1.4
Industrial					
Combustion	0.8	0.8	0.2	—	1.8
Feedstock	—	—	1.8	—	1.8
Lubricants/petroleum coke	—	—	0.3	—	0.3
Total Non-Transportation Use	2.0	2.3	2.6	0.5	7.4

[1] Includes kerosene.

[2] Distillate feedstocks included in this category. Also includes other petroleum products used as chemical feedstocks, lubricants, waxes, and petroleum coke.

Sources: *Monthly Energy Review: July 1980* (U.S. Department of Energy, Washington, D.C., July 1980). *EIA Annual Report to Congress: 1980*, Volume Two (U.S. Department of Energy, Washington, D.C., 1981). *U.S. Energy for the Rest of the Century* (U.S. Department of Commerce, Washington, D.C., July 2, 1980). *Federal Energy Data System: Statistical Summary, Update.*

constraints on gas.[3] The findings of that survey show that 0.9 mbde of immediately displaceable oil continues to exist in the industrial and power plant sectors. Actual displacements of oil by gas in 1980, as contrasted with 1978, amounted to 0.55 mbde. Displacements in the residential sectors totalled over 69,000 mbde, with the remaining 0.5 mbde occurring in the industrial and power plant sectors.

Category Two—other oil uses that can in the near-term (0-5 year time-frame) be displaced by gas and coal, including the select use of gas with coal in dual-fuel capable facilities.[4] This second category of oil use, that which is displaceable in a longer time-frame, consists of some 3.6 mbde of replaceable oil. This category includes oil combustion in industrial and electric utility boilers that are not currently connected to the gas system, as well as liquid petroleum gas (LPG) combusted directly in industrial sector applications. Also included in this second category of oil use is the 1.3 mbde of fuel oil use in the residential and commercial sectors.

Category Three—oil use that is difficult to displace with alternative fuels. The third category of non-transportation oil use consists of industrial, residential and commercial applications whose use of oil products can only be replaced by alternative fuels in the long-term (beyond five years). This category includes LPG consumption in the residential and commercial sectors (generally in dispersed locations not served by gas utilities), lubricants, waxes and petroleum coke products; asphalt; and liquid hydrocarbons used as chemical feedstocks. These oil uses totalled 2.9 mbde in 1980.

The U.S. imported an average of 6.4 mbde of crude oil and oil products in 1980. If the nation had displaced all oil used in Category One, imports would have been 14% lower (a balance of payments savings of $11 billion at $34 per barrel). If the nation had displaced all oil use in Category Two as well, our oil import level would have been 72% lower, (balance of payments savings of over $57 billion). Table 2 summarizes replaceable U.S. oil uses (Categories One and Two).

TABLE 2

OIL USE REPLACEABLE BY GAS AND COAL
(million barrels per day crude oil equivalent, mbde)

	Category One	*Category Two*	*Total Replaceable Oil Consumption*
Industry			
LPG in direct combustion	—	0.2	0.2
Residual Oil	0.4	0.4	0.8
Distillate	0.1	0.7	0.8
Subtotal	0.5	1.3	1.8
Electricity Generation			
Residual Oil	0.4	0.9	1.3
Distillate	—	0.1	0.1
Subtotal	0.4	1.0	1.4
Residential and Commercial Buildings			
Residual Oil	—	0.2	0.2
Distillate	—	1.1	1.1
Subtotal	—	1.3	1.3
Total	0.9	3.6	4.5

Note: Category one includes non-transportation oil uses that can virtually immediately be displaced by gas, category two includes other oil uses that can be displaced in the near-term by gas or gas and coal in dual-capable facilities

ARTICLE #7

NATURAL GAS PRICES AND THE ECONOMIC PROBLEMS OF DEREGULATION

By
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HISTORY OF NATURAL GAS REGULATION IN THE UNITED STATES

The natural gas pipeline industry has long been considered a decreasing cost industry since long-run average costs decline as pipe diameters increase. Thus, the industry was characterized early-on as a natural monopoly (Griffin and Steele, 1980, p. 244), and therefore a candidate for regulation. The Natural Gas Act (Public Law 75-688), passed in 1938, established the Federal Power Commission (FPC). The FPC was given the power to regulate, under the Natural Gas Act (NGA),

- prices of gas sold in interstate markets,
- conditions of sale of gas in interstate markets, and
- rate of return earned by interstate pipelines,

according to Dickens and Thrasher (1979, p. 4). The NGA specifically exempted **production** of natural gas from FPC jurisdiction, however (Carlson, et al, 1981, p. 1; Dickens and Thrasher, 1979, p. 4).

In 1954, the U.S. Supreme Court **(Phillips Petroleum** vs. **Wisconsin)** interpreted certain sections of the NGA to extend FPC regulation of interstate pipeline companies to include the price of gas purchased by the pipelines (wellhead price). This extension was based on the argument that wellhead prices had "a direct and substantial effect upon prices paid by the ultimate consumer." (Dickens and Thrasher, 1979, p. 4). Since regulation of natural monopolies is theoretically justified by its beneficial effect on consumers, such extension of FPC power may have been reasonable.

Several methods of wellhead price regulation were attempted which became administrative nightmares. In the 1960's, the FPC turned to the technique of "area-wide" pricing which created two vintages of gas. "New" gas could be priced at the highest previously certified gas price in the area; "old" gas was priced at the average price for the area. It was necessary, as time passed, for the FPC to create new vintages, each selling at a higher price (Griffin and Steele, 1980, p. 244). Thus a precedent for different price categories was set for gas carried by interstate pipelines.

The NGA did not extend FPC regulatory power to gas carried by intrastate pipelines. As a result, prices for natural gas produced and used within a particular state could vary according to the laws of supply and demand. During the 1970's, intrastate prices rose relative to interstate prices (Carlson, et al, 1980, p. 3) as shown in Figure 6.

A second constraint was imposed on interstate gas sales by the FPC. According to Dickens and Thrasher (1979, p. 5) natural gas reserves, if once committed to interstate sales, could not be withdrawn from that market. Thus, a producer could not switch gas from a particular deposit back and forth from interstate to intrastate markets. This was the case even if production from a well ceased and then was resumed (Dickens and Thrasher, 1979, p. 5). The result of this constraint is shown in Figure 7. Note the steady decline in reserves committed to interstate markets — where the price was regulated — during the late 1960's and early 1970's. Additions to reserves during the same period are shown in Figure 8.

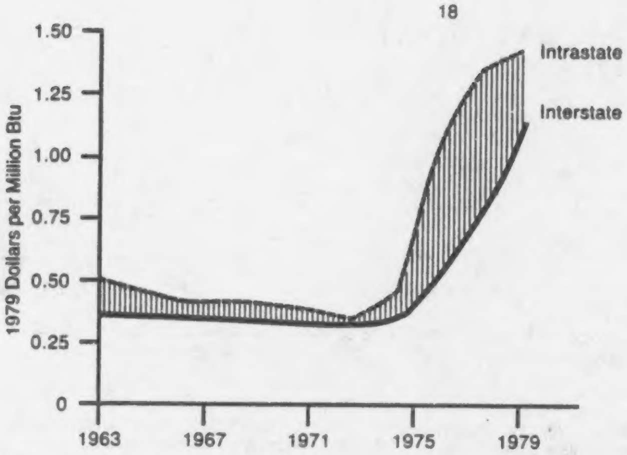

FIGURE 6 — Average Pipeline Acquisition Price of Natural Gas

Source: Carlson, et al, 1980, p. 4.

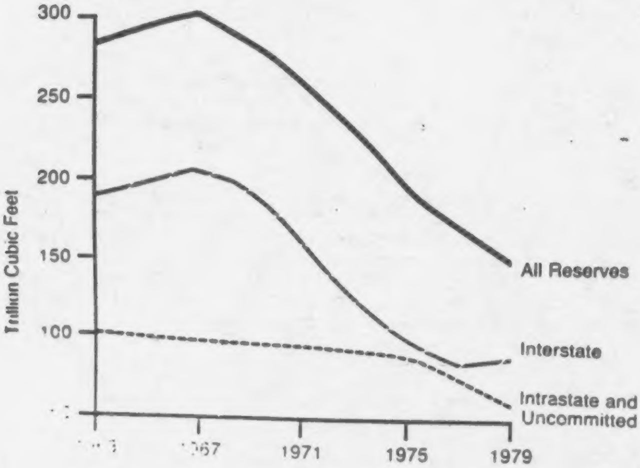

FIGURE 7 — Reserves of Natural Gas in the Lower 48 States

Source: Carlson, et al, 1980, p. 2.

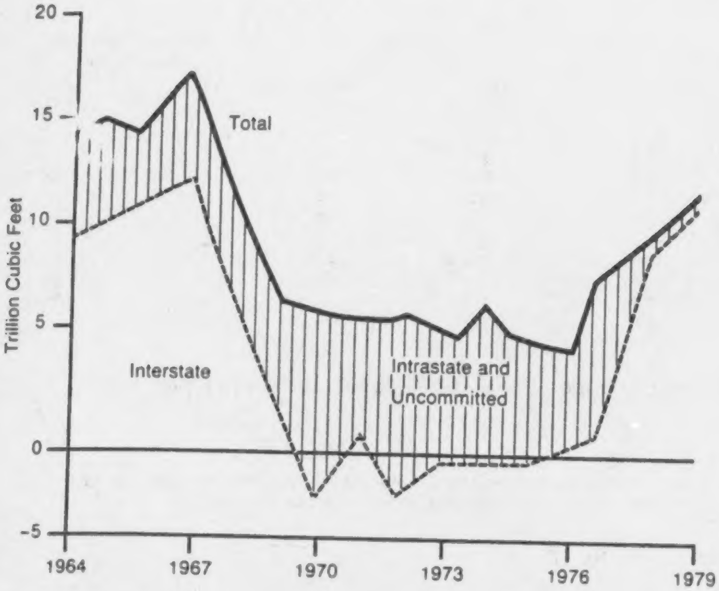

FIGURE 8 — Reserve Additions of Natural Gas in the Lower-48 States, Excluding the Gulf of Mexico

Source: Carlson, et al. 1980, p. 3.

There seems to be a clear relationship between wellhead price (Figure 6) and additions to reserves (Figure 8). This relationship is further illustrated by Table 1 and Table 2. As a result of regulatory changes to be discussed in the next section, the price difference between the two markets began to decrease in 1978-1979 and the reserve additions gap began to close.

TABLE 1

Interstate Total Reserve Additions vs. Intrastate Associated and Non-Associated Gas (Excludes Alaska)

Year	AGA Reserve Additions Excluding Revisions (Tcf)	Interstate New Supply[a]		Inferred Intrastate New Supply[b]	
		Tcf	Percent	Tcf	Percent
1966	14.8	10.0	68	4.8	32
1967	14.8	9.9	67	4.9	33
1968	9.8	6.4	65	3.4	35
1969	9.6	6.2	64	3.4	36
1970	11.3	3.5	31	7.8	69
1971	11.1	2.2	20	8.9	80
1972	10.7	5.0	47	5.7	53
1973	10.1	1.7	17	8.4	83
1974	9.7	2.4	25	7.3	75
1975	10.0	1.3[c]	13	8.7	87

Source: Federal Power Commission, Opinion 770-A, Docket No. RM 75-14, page 116.

[a] Form 15. FPC. excluding revisions.

[b] Derived by assuming that intrastate reserve additions are equal to the difference between total AGA reserve additions and the reserve additions committed to the interstate market.

[c] Preliminary.

From Natural Gas Supply Committee. 1977. p. 21.

TABLE 2

A Comparison of Interstate Ceiling Prices and Intrastate Prices

Year	Quarter	Interstate New Gas Ceiling Price	Intrastate New Contract Volumes		Renegotiated and Amended Intrastate Contracts		Percent of Intrastate New Contract Volumes at 201-250 ¢/Mcf
			Highest Price	Average Price	Highest Price	Average Price	
		(¢/Mcf)	(¢/Mcf)	(¢/Mcf)	(¢/Mcf)	(¢/Mcf)	(%)
1977	January-March	144	239.0	183.7	235.3	117.8	28.7
1976	October-December	143	233.0	180.4	217.1	165.5	10.0
	July-September	142	216.8	143.4	229.4	163.3	1.9
	April-June	52	216.1	158.8	233.9	165.6	7.4
	January-March	52	212.8	154.8	220.9	178.0	0.2
1975	October-December	51	215.9	120.2	211.0	153.4	9.5
	July-September	51	220.3	141.8	235.2	139.2	5.7
	April-June	51	211.5	140.5	232.2	155.6	2.9
	January-March	51	207.2	114.6	217.1	130.0	0.3

Source: FPC quarterly reports on intrastate prices.

From: Natural Gas Supply Committee. 1977. p. 23.

Not only were reserve additions different in the two markets, but production level changes also show the effects of price changes. Compare Figure 6 with Figure 9, below. Notice, too, that as intrastate prices increased rapidly in the 1973-1977 period, interstate gas purchases declined.

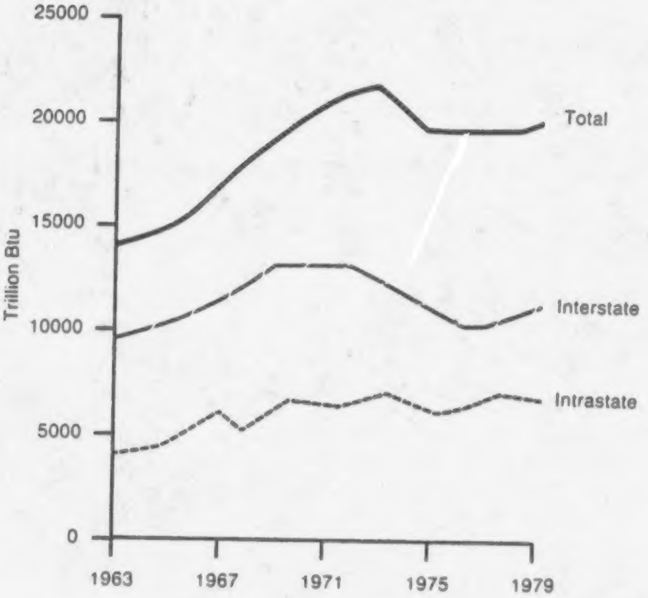

FIGURE 9 — Pipeline Purchases of Natural Gas

Source: Carlson, et al, 1980, p. 4.

A summary of the situation in the natural gas markets during the 1960-1978 period sets the stage for major regulatory changes which occurred in 1978. Important points are listed below.

1. Intrastate gas prices varied with market conditions.
2. During the 1960's intrastate buyers could satisfy their gas requirements by offering a price slightly higher than the most recent FPC vintage price.
3. Leftover gas not purchased by intrastate buyers was purchased by interstate buyers; i.e., interstate buyers were the marginal customers and, as a result, interstate prices were nearly equal to intrastate prices during the 1960's (see Figure 6).
4. During this period, much of the newly discovered gas was found in the Southwest.
5. The sharp divergence in price between the two markets which began in the early 1970's (see Figure 6) resulted in few new interstate gas contracts in the rapidly growing Southwest, which was able to "absorb the available supply of newly discovered gas at a price considerably higher than that set by the FPC" (Griffin and Steele, 1980, p. 244).
6. Consumers outside the Southwest, as a result, faced increasing shortages as their demand for (interstate) gas increased.

Three additional facts, listed below, stressed by the Natural Gas Supply Committee (1977, p. 24) in its analysis of the situation prior to 1978 need to be considered.

1. Intrastate markets were clearing on a production basis as well as on a reserves additions basis.
2. There were no surpluses of natural gas available in the intrastate markets which could benefit the interstate market. Natural gas was a fully employed resource in both markets.
3. Healthy competition existed in the intrastate markets as evidenced by disparity in price between highest and average prices for new contract volumes.

As early as Winter 1972, gas shortages occurred in the interstate market. The FPC took several actions such as assignment of priorities to certain consumer classes. State regulatory authorities also tried to alleviate the shortages. However, the basic cause of the shortage, the interstate intrastate tension, was not confronted until Congress passed Public Law 95-621, an Act for the relief of Joe Cortina of Tampa, Florida, who was concerned about tariffs on musical instruments, which contains as an admendment, the Natural Gas Policy Act of 1978.

THE NATURAL GAS POLICY ACT OF 1978

The Natural Gas Policy Act of 1978 was the result of a compromise between the U.S. Senate and the U.S. House of Representatives. Each recognized a need to deal with the interstate/intrastate dual natural gas market problem. In addition, both desired to avoid disruptive changes in natural gas prices. The issue was whether equalization of the two markets should be accomplished through deregulation of the interstate market (Senate preference) or through regulation of the intrastate market[3] (House preference). The NGPA as finally adopted is a combination of the two approaches. Essentially, Title I of the NGPA regulates wellhead prices in both markets, aiming for an orderly transition of both markets to deregulation in 1985. The structure of regulation which evolved after the **Phillips** case was changed in 3 major ways by the NGPA, reflecting the goal of orderly transition to deregulation, as follows:

1) Jurisdictional authority over interstate **and intrastate** gas was granted to the Federal Energy Regulatory Commission (FERC).
2) A set of specific wellhead prices was declared, with prices received by producers determined by the following criteria:
    - physical characteristics of the wells
    - deposits from which the wells produced
    - market to which the gas had been committed (interstate or intrastate).
3) "Incremental pricing" rules were established for allocating the costs of producing certain categories of gas among the several types of end-users served by interstate pipeline companies.

To be more specific, Title I established two parameters for natural gas prices. The first is maximum lawful prices for several classifications of "first sales" of natural gas. These classifications are based primarily on the characteristics of the well from which the gas is produced. The second parameter is a set of price escalators for new gas. The objective of the escalators is for the price, in 1980 dollars, to reach a price equivalent to a crude oil price of $15 per barrel just prior to decontrol of new gas in 1985. These escalators were designed in 1978 - subsequent unexpected changes in the price of oil may cause the transition to decontrol in the gas market to be more difficult than expected.

Under NGPA there is a so-called "old gas cushion", which is not decontrolled. The idea is to average the controlled old gas prices (which are low) with the decontrolled prices (which will rise) - resulting in a gradually increasing average price. The goal is for the average price to reach the supply/demand equilibrium price by 1985.

Rotan Mosle (1982, p. 2) points out that FPC and FERC had attempted similar averaging approaches in 1974, 1976 and 1977-78, trying to equalize intrastate and interstate prices. Figure 10 shows the failure of these attempts.

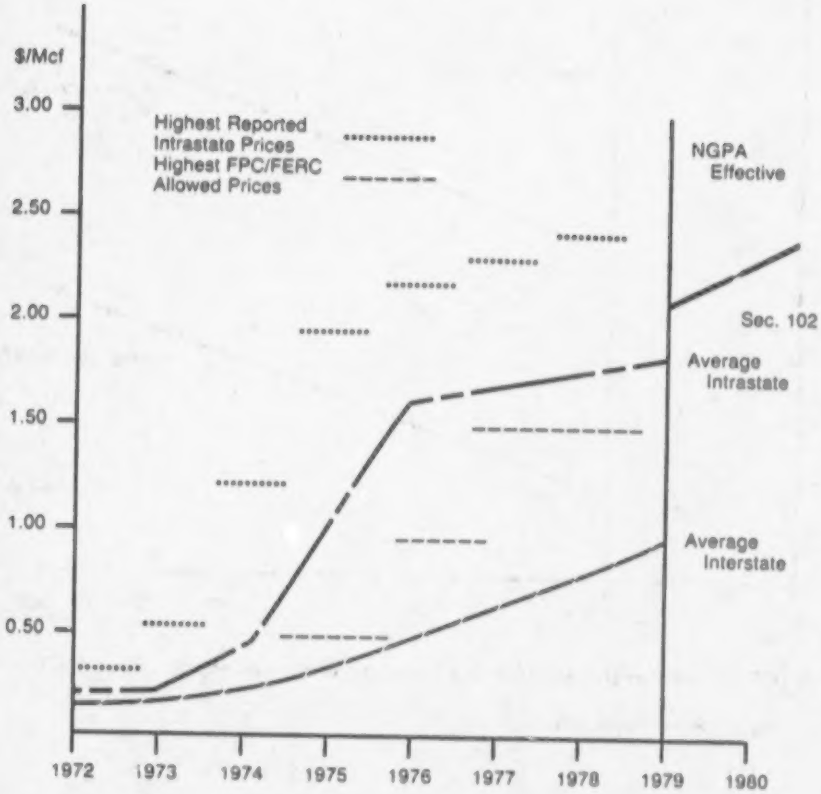

FIGURE 10 — Interstate/Intrastate Average Wellhead Prices

Source: Rotan Mosle, 1982, p. 3.

The attempt by Congress, through the NGPA, to equalize prices in the two markets has had equally poor results as shown in Figure 11, which shows the result of four years of price action under NGPA.

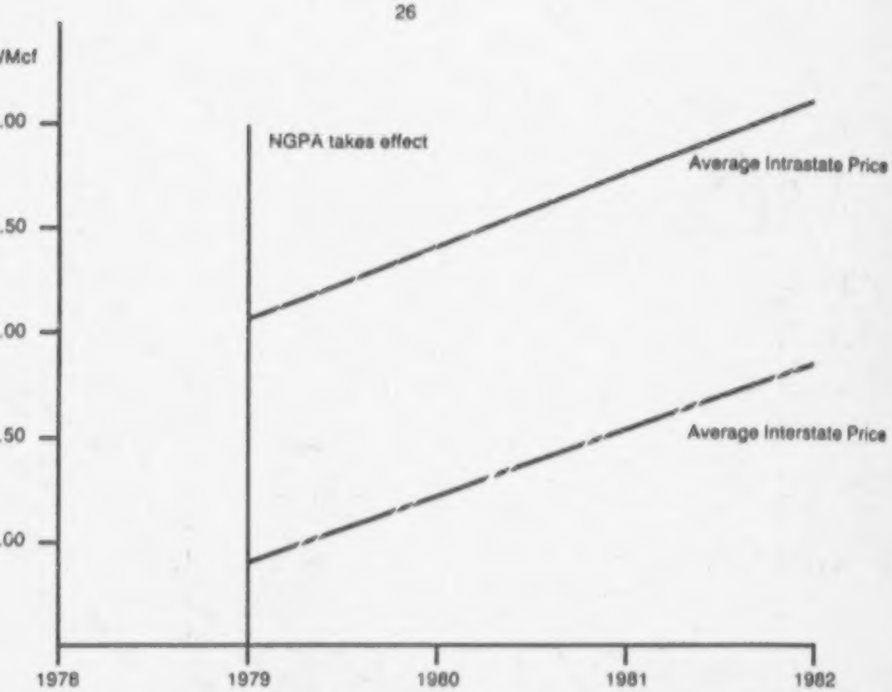

FIGURE 11 — Interstate/Intrastate Average Wellhead Price (Post 1979)

Source: Rotan Mosle, 1982, p. 4.

TITLE I - WELLHEAD PRICING

Title I of NGPA separates natural gas into several categories, with the separating criteria being type of well and age of well. Each category is defined under one of the nine sections of Title I. A summary of the provisions of Title I is provided in Table 3, which contains a brief description of the defining criteria for each section. Figure 12 illustrates the timing of decontrol and the relationship of the various Title I categories.

In order for the reader to better understand Title I gas categories, a brief description of each is given below.[4] In addition, comparisons of NGPA projected prices are made with projected prices under the old system. These comparisons are based on the report of the economic analysis done by the staff of the House Subcommittee on Energy and Power in 1978. This study was done prior to passage of NGPA and was important background information in the Congressional process of passing the law. Recent comparisons are a part of the next section of this report.[5]

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[4] In the gas business, a reference to "102 gas" means gas to which Section 102 pricing rules apply. Similar expressions apply to other gas categories.

[5] This discussion is based heavily on material from the report of the House Subcommittee on Energy and Power staff (1978), the ICF report (1981) prepared for the Department of Energy and the Price Waterhouse (1978) pamphlet.

EVIDENT EFFECTS OF NGPA AS OF SPRING 1982

By January 1982, NGPA had been in effect for three years, two years under the Carter administration and one year under Reagan. During the fall of 1981 there was much discussion of (and some speculation on) the idea of accelerated total deregulation of natural gas.

For example, Secretary of Energy James B. Edwards, writing in the American Oil and Gas Reporter (July 1981, p. 81), makes the statement,

> "This administration is committed to the accelerated deregulation of natural gas. Deregulation will encourage exploration and development, expand supply, increase incentives for conservation, and help reduce our vulnerability to foreign oil disruptions."

President Reagan was quoted in the March 8, 1982 issue of Oil and Gas Journal (1982c, p. 130) as saying, ". . . natural gas decontrol remains an essential component of a sound energy policy." The same article reports, however, that because of a "heavy legislative agenda" the President will not push for accelerated decontrol in 1982. A later article (Oil and Gas Journal, 1982e) reports introduction by Rep. Gramm (D-Tex) of a gas decontrol bill which could bring changes in NGPA in January 1983. The American Association of Petroleum Geologists called, in early January 1982, for acceleration of the NGPA price decontrol schedule, hoping to achieve total decontrol by 1985 (Oil and Gas Journal, 1982a). Other examples abound in the literature.

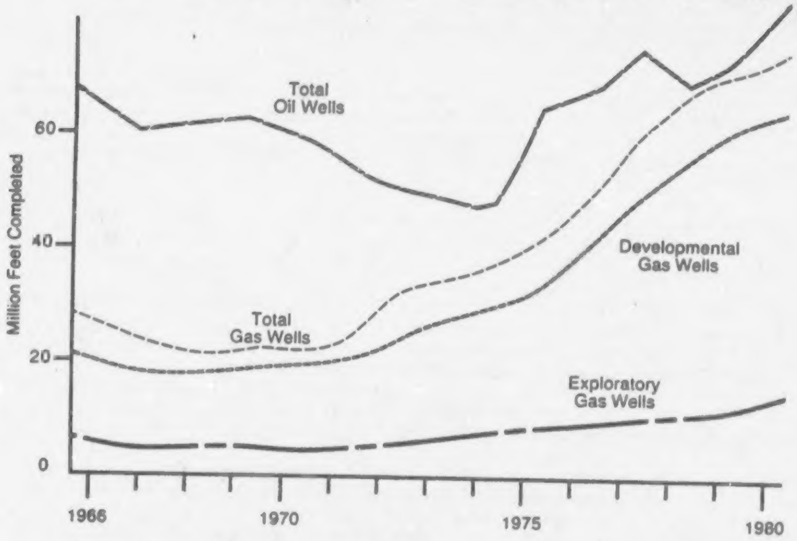
Why has this discussion of acceleration of natural gas decontrol been taking place? Have the results of partial decontrol under NGPA been so good that early total decontrol is desirable? Has NGPA shown such poor results that it needs to be replaced? What have been the effects of NGPA on price and supply of natural gas? This section of the report attempts to answer the last of these questions and the next major section is a summary of the expectations for total deregulation.

SUPPLY EFFECTS

Early effects of NGPA indicated that higher prices would indeed bring forth more gas. Rudnitsky and Lappan (1980, p. 65) point out that additions to gas reserves in the 1978-79 period were the largest since the 1960's, indicating an increase in successful exploration. Flanigan (1979, p. 66) indicates that the increase in price allowed by NGPA caused drilling for gas wells to increase by 33 percent in the first two months of 1979 compared with a 3.1 percent decline in oil drilling for the same period. This sharp increase in gas drilling could, however, have been the effect of drilling programs which had been put on hold pending passage of NGPA. The AGA reported that 14.3 Tcf was added to US gas reserves in 1979 — a twelve year high and 35 percent more than in 1978 (Curtis, 1980, p. 61). George Lawrence of the AGA (1980), writing in the Western Oil Reporter, stated "without question, the NGPA has exceeded expectations in spurring new natural gas exploration." Lawrence predicted that natural gas well completions in 1979 would be 13 percent higher than in 1978.

Later data, however, paint a less rosy picture. The current head of FERC complained that NGPA hasn't solved the nation's gas supply problem and pointed out that gas reserve additions during the years since NGPA had been "essentially flat" (Oil and Gas Journal, 1981g). An economics professor at North Carolina State University, Edward Ericson, was quoted as saying that the percentage increase in new gas completions has steadily declined since passage of NGPA (Oil and Gas Journal, 1981g). Jack Elam, chairman of the Process Gas Consumers Group, commented that annual gas well completions have increased at a slower pace since passage of NGPA than in five of the six preceeding years (Oil and Gas Journal, 1981g). Gas well completion footage from 1966 through 1980 is shown in Figure 17 and Table 13. Note that the curve showing total gas wells completed becomes less steep after 1978, indicating a slower rate of increase. Exploration, however, increased more rapidly in 1980 as indicated by the slightly steeper section of the exploratory wells curve. Oil wells, however, increased very rapidly in the 1978-1980 period, due to rapid increases in oil prices and complete deregulation of oil in 1980.

FIGURE 17 — Gas and Oil Well Completion Footage, Lower 48 States, 1966-1980



Source: Jensen Associates, Inc., 1981, p. 36.

TABLE 13

U.S. Natural Gas

	1975	1976	1977	1978	1979	1980
Year End Reserves (Bcf)	228.200	216.026	208.877	200.301	194.916	199.021
Production (Bcf)	19.718	19.542	19.447	19.311	19.910	18.699
Reserve Additions (Bcf)	10.786	7.368	12.298	10.735	14.525	16.723
Gas Wells Completed**	7.580	9.085	11.378	13.064	14.681	15.730
Gas Discoveries/Wells (Bcf)	1.42	0.81	1.08	0.82	0.99	1.06

* Reserves, additions, and production statistics are not consistent from 1979 to 1980. The American Gas Association ceased compiling data in 1979. The Energy Information Administration compiled the data for 1980.

** Source: American Petroleum Institute

The GAO surveyed gas producers in 1980 to ascertain the effects of NGPA. Data collected by the GAO indicate a production increase of 1.6% in 1979. Table 14 shows the GAO results compared with AGA data. The GAO data represent 54 producers who produced approximately 48 percent of the 1979 total gas production. The two sets of data agree with respect to trend, both showing the early effect of NGPA.

TABLE 14

Natural Gas Production

	GAO Survey		AGA	
Year	Production (Tcf)	% Change	Production (Tcf)	% Change
1975	10.128	-	19.719	-
1976	9.857	-2.7	19.542	-0.9
1977	9.596	-2.6	19.447	-0.5
1978	9.308	-3.0	19.311	-0.7
1979	9.455	+1.6	19.910	+3.1

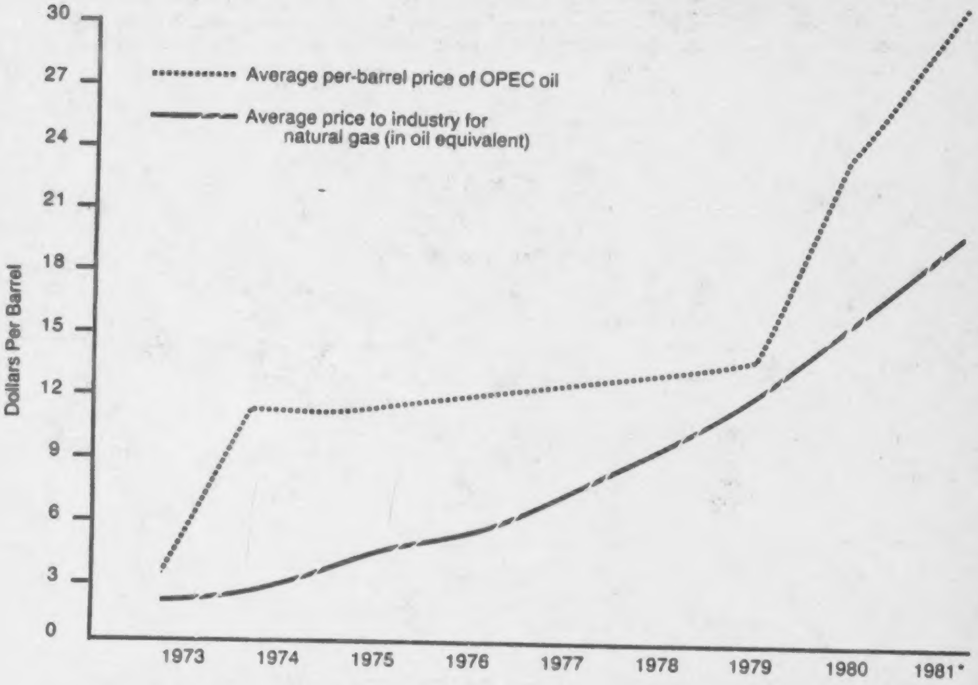
Source: Heller, 1981, p. 14-15.

The 107 tight gas is priced significantly higher than other types of gas. This high ceiling has encouraged drilling in tight sands; by April 1982 FERC had received 8179 well applications for drilling in these formations. Tight gas sand areas designated by FERC since October 1979 cover approximately 102 million acres — 5.2 percent of the land area of the lower 48 states (Hagar and Petzet, 1982). Applications now pending with FERC and with state agencies would add 54.3 million acres to tight sands designated areas (Hagar and Petzet, 1981).

PRICE EFFECTS

Average gas prices have risen steadily since passage of NGPA, as shown by Figure 11. As indicated in the figure, intrastate prices were still much higher in 1982 that were interstate prices. The comparison with oil prices shown in Figure 18 indicates that gas prices have continued to rise along the same general trend as prior to NGPA, while OPEC oil prices have increased sharply since 1979.

FIGURE 18 — Comparison of Natural Gas Prices with OPEC Oil Prices



*Estimate
Based on Curtis, 1981, p. 31.

The price effects discussed above are based on average prices. There have also been other types of effect. For example, regional differences in price increase are illustrated in Figure 19. It should be noted that Texas and Louisiana were major intrastate producers prior to NGPA and this is a reason that the smallest average increase occurred in the "major producing states" region.

TABLE 15

Natural Gas Ceiling Prices ($/MMBtu)

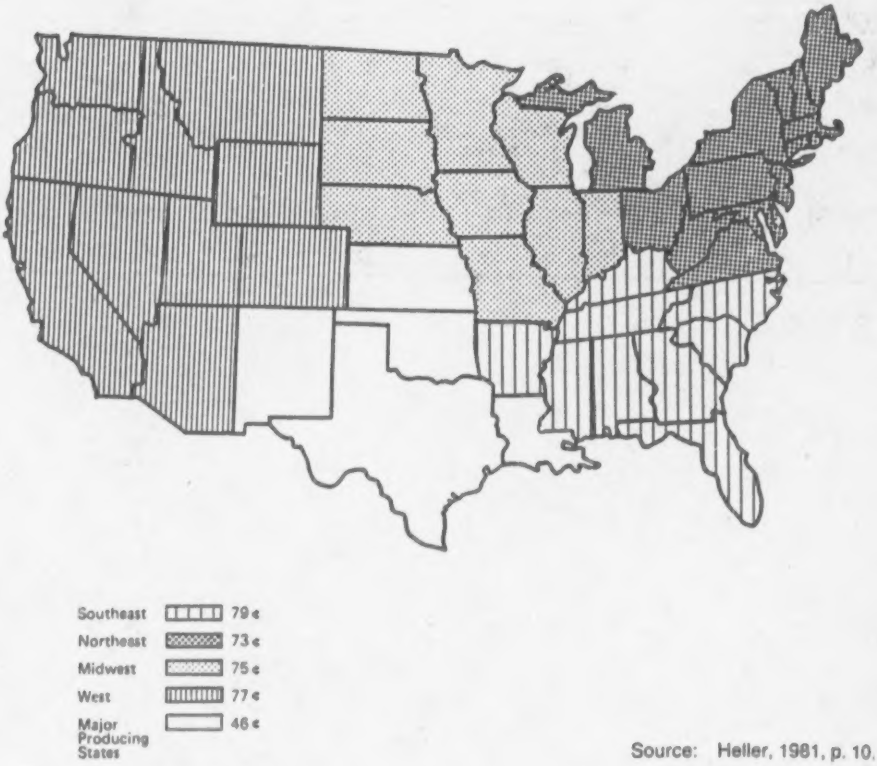
NGPA Section	Category of Gas	July 1979	July 1980	July 1981	July 1982
102	New natural gas and certain OCS gas	2.220	2.504	2.840	3.152
103	New onshore production wells	2.062	2.255	2.476	2.650
106(b)(1)(B)	Alternative maximum lawful price for certain intrastate rollover gas	1.176	1.286	1.412	1.511
107(c)(5)	Gas produced from tight formations	4.124	4.510	4.952	5.300
108	Stripper gas	2.375	2.680	3.041	3.377
109	Not otherwise covered	1.700	1.867	2.050	2.194

Source: FERC

Summary

There is disagreement about the supply effects of NGPA, but evidence shows that additions to reserves increased steadily over the 1975-1980 period (see Table 13) as did the number of gas well completions (Table 13, Figure 17). It is not known what these trends would have been without NGPA. It is, therefore, impossible to attribute the observed increases in 1979-1980 solely to the price increases allowed under NGPA. It is correct, however, to attribute the increase in deep gas production and in tight sands exploration to the high prices allowed by NGPA. Stuart (1981, p. 154) makes the statement, ". . . federal policy has created a powerful incentive for the most expensive gas to be produced first and the cheapest stuff last — the exact opposite of the classical theory of resource development." Stuart's comment sets the stage for discussion of possible effects of total deregulation.

FIGURE 19 — Area Price Increases per Mcf (1978-1st Qtr. 1980)

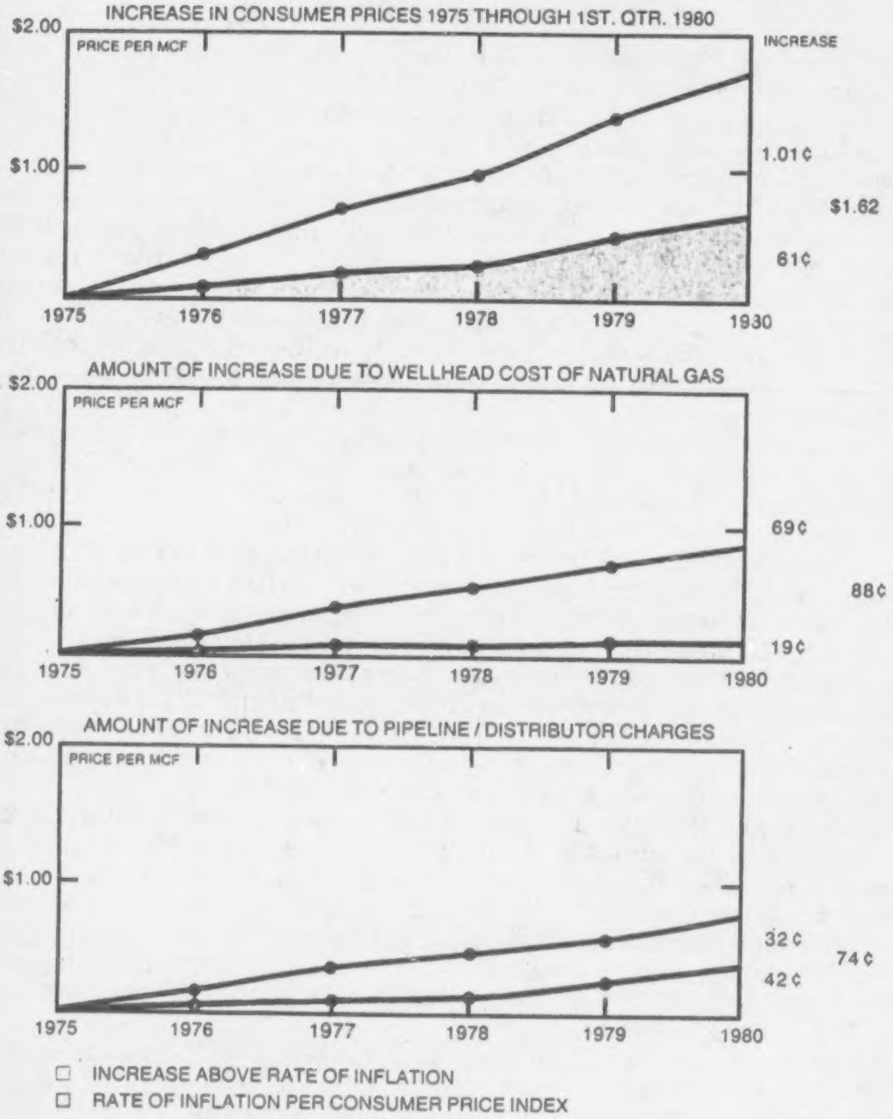


Source: Heller, 1981, p. 10.

Other effects depend on the complexity of NGPA. For example, deep gas (section 107 gas from wells deeper than 15,000 ft.) has sold for as much as $9.77/MMBtu, a price which is equivalent ot $57/bbl for crude oil (Stuart, 1981, p. 153). Deep gas was deregulated in mid-1979. Additionally, reference was made above to the increased interest in tight sands caused by the relatively high ceiling price for gas produced from these formations.

Maximum allowable prices for certain NGPA categories are listed in Table 15. Recall that these ceilings apply to wellhead prices and are a function of the inflation rate. A comparison of the effects of wellhead price increases, inflation, and pipeline/distributor prices are shown in Figure 20. Approximatgely 43 percent of the increase in consumer gas price form 1975 to 1980 was due to increase in wellhead price.

FIGURE 20 — Components of Gas Price



Source: Heller, 1981, p. 8.

The CHAIRMAN. Mr. Murray.

STATEMENT OF WILLIAM J. MURRAY, JR., INDEPENDENT PETROLEUM ENGINEER

Mr. MURRAY. Mr. Chairman. Members of the committee.

I know I am supposed to start out by saying it is a privilege, and it is, but since I got in at 2 a.m., and was up working on this chart at 6 a.m., I am not sure I would want to repeat it every Saturday.

Senator McClure, not that my endorsement of your statements on oil adds anything to your extreme credibility, but I would like to start out by saying that I strongly concur and if time permitted since I have been around a little bit longer, I would like to cite some instances in which this country became complacent because we were counting on oil-producing capacity we didn't have.

It wasn't anybody's fault; it was just the inherent optimism of all men to think they can do more than they can when they have occasion to try it.

Now, my main message here today is to say that I feel that we may be in that same situation with gas. Possibly I should identify myself. I am Bill Murray, and who I am doesn't matter except to what extent it has a measure of credibility.

I am a petroleum engineer. I have taught that subject. I am a energy consultant nowadays, whatever that is. I have served for 16 years as a member of the Railroad Commission, 6 years as its Chairman. If any time permitted and Senator Domenici was here and wanted to ask, I wrote those proration rules on gas, and of recent years as a consultant, and that is primarily my purpose in speaking today. I consult with 2 million consumer clients, most of them residing in the cities of Austin and San Antonio, for which cities I have been a consultant for about 10 years.

Now, we are strongly opposed to take-or-pay. I would almost ask for legislation to abrogate it until I heard Senator Metzenbaum, and as a private enterprise I don't like to abrogate contracts, so in Texas we have found a way around it; and we haven't paid one cent although billions of dollars of take-or-pay have accrued, we haven't paid one cent. I would leave it there, but I can, if time permits or interest occurs, give the details of how that system works. It always needs fine tuning.

My chart—and, Mr. Chairman, is it visible there? I don't know whether the audience is interested or not. Oh, you have it there. Now, what I did, sir, last night, or 6 a.m., this morning.

This is Railroad Commission data, but it is retrieved from their computer and it is in the form that hasn't been previously available, and two nights ago they ran an all-night computer run and got the 1982 data which I put in pencil on this chart, and if I am right, it doesn't change the conclusions, but if it is appropriate to speak from the chart.

The CHAIRMAN. I might just note. I hope you will provide us the pencil data, which does not appear on the chart that you attach to your statement.

Mr. MURRAY. The top solid line is the Texas gas production. On the left you will note that it is in cubic feet. For my purposes I rounded it off in 7.5 trillion cubic feet was our maximum production from gas wells; this doesn't include the casing head gas that also comes with oil production, and as was earlier stated if we don't use it it will be flared.

Those are actual numbers. Now, the green area represents this so-called gas glut or gas bubble, and it isn't really as big as I fear we have credited it with being.

Now, the top dotted line called estimated total capacity will acknowledge that is a number perhaps unique with me, because for a number of years I have chaired the Voluntary Allocation Committee and until 1982 when someone decided to cancel a winner we have had periods of time when our peak demand could not be met with all of our producing capacity, and we would therefore, on a voluntary basis, ask some companies to shut in industry, electric utilities, and on January 10—that week in 1982, we even had to shut down a third of the schools in Texas, and when I am staying up all night calling every company—can you give us a little more gas, and will you voluntarily let it be moved, I get a pretty good idea of how much gas we can produce when we are wide open.

So, all of the points on the upper line of the green area I consider the best estimate possible, but for 1982 or right now, since the recession, the loss of markets to foreign countries, and the lack of cold weather, and we had a cool summer too, I just haven't had a chance to come up with a number.

But I am convinced, and this is disturbing, and this will be contradicted and I hope successfully so, because I would sure like to be shown wrong, but over a 5-year period of time, from 1977 through 1981, in which we completed 26,000 new gas wells in Texas, we lost 1 trillion cubic feet of deliverability; so we got a surplus, not because supply has been increasing but because our demand is going down.

And we always overstate a surplus, every producer thinks he can do—as I have already said, a lot more than he can when you ask him to do it.

Now, these other lines on the chart are a breakdown by vintage of gas, and from my own charts I have done every year, but I group these together for all of the gas older than 1960, for the gas for 5-year intervals.

Now, Senator, the pencil marks on there are this morning put on from the Commission's overnight computer run. They are just now getting me all the data for 1982. They do not materially change the conclusions or the projections.

And you will note how this old gas, all of the wells are declining, and it is not impossible that we could debate what to do long enough—you could—that the gas would be gone, and it would be a moot question.

But that is disturbing to see the decline of this old gas.

And now, the bottom line of this, sir, is that if you project what all the wells that were completed on the first of the year of 1982—I don't want to make a projection for 1982 because those wells came in early and late, and I don't have enough history to see what they can do; but everything older than that, according to this line, if we use my computer semilog deal, I get 2.815 trillion, and if you will forgive me for rounding off on a generous side, let's say that only 3 trillion feet of gas will be available from the old wells.

And this is by 1985, and by 1985 I hesitate to project demand. You draw your own conclusions there.

And I will just tell you what the red is in just a minute. Somewhere from 40 to 48 percent of the gas that we need in 1985 is going to have to come from wells that haven't been drilled yet.

Now, back before when I said these 26,000 wells drilled, and I think considerably because of NGPA—that was the NGPA years, 1 year in anticipates—producers are like the stock market investors; they do about as much on what they think is going to happen as what does happen; and we had 1 year of anticipating in NGPA, and the drilling surge—the chart I will show you in a minute—went up in 1978 even before it was enacted.

But in those 5 years——

The CHAIRMAN. Mr. Murray, your time is up.

Mr. MURRAY. Thank you, sir. That is my message. It is a privilege to be here.

The CHAIRMAN. It is very much appreciated, and we will get back to some questions in a moment.

[The prepared statement of Mr. Murray follows:]

STATEMENT OF
WILLIAM J. MURRAY, JR.
INDEPENDENT PETROLEUM ENGINEER

Mr. Chairman:

Members of the Committee:

I appreciate the privilege of appearing today and although there are many aspects of the proposed bill about which I would like to comment, in the interest of time and to avoid probable duplication, I will primarily discuss present and projected supplies of natural gas and express my concern over adequacy for the future.

My name is Bill Murray. I am a consulting petroleum engineer from Austin, Texas, and for over four decades have been intensely studying Texas' and the nation's oil and gas production capacity. Enough of my varied experience will be stated to help you judge the credibility of my serious concerns relative to national security and consumer welfare. I hold B.S. and M.S. degrees in petroleum engineering, taught this subject at the University of Texas, was employed as a conservation and reserves engineer by the Oil and Gas Division of the Texas Railroad Commission and later by the Federal government for a six state area, including Texas and the other principal oil and gas producing states. I served for sixteen years as a member, including six years as Chairman, of the Texas Railroad Commision, which as I presume most of you know, is the oil and gas conservation regulatory agency as well as the transportation and gas utility regulatory body. I have also had "practical experience" although I consider working for government conservation agencies as important and practical as any career to which a conservation oriented engineer could devote his life. I have engaged in all types of oilfield work, I have helped manage drilling contracting firms and participated in independent oil and gas exploration, development, production and secondary recovery operations, and have organized and managed gas gathering and transportation companies. At present, as a consultant, I have oil and gas producing company clients but my principal concern and the primary reason for my appearance today is for some two million consumer clients, mostly residing in Austin and San Antonio, for which cities I have been an energy consultant for ten years. In their behalf, I would be pleased with any bill which reduced natural gas prices or prevented escalation if such action did not discourage the continued exploration for and development of new gas reserves and delivery capacity. But I greatly fear that the seriousness of the present supply situation and the adverse effect of the proposed legislation on future supply is being overlooked.

At this point, it would seem appropriate to make reference to a chart which appears in my prepared testimony and an enlarged copy I now display. The basic data are from Texas Railroad Commission records. I can attest to the accuracy of the solid lines on the chart but you and your staff can make your own projection as a check on the validity of mine.

The top line is a plot of the total annual Texas production of gas from gas wells for the period 1970 through 1982. This does not include casinghead gas which is gas associated with oil and must be produced whenever oil is produced. The lower lines reveal the quantity which comes each year from wells of certain vintage. I have separately plotted each year for my own projections but for this chart, I have grouped data in five-year brackets after 1960. The dotted lines are my smooth curve projections adjusted for computer calculations on a semi-log basis and with allowances for less than capacity production in recent years.

Table 5

The line above the total production curve is my estimate of the total annual delivery capacity for the state of Texas since 1977. It is based on actual metered production during peak demand periods when total demand could not be met. The 1982 capacity can only be estimated because, as a result of the economic recession, a cool summer, and a mild winter, Texas wells have not produced at capacity since the week of January 10, 1982. However, for the five-year period 1977 through 1981 inclusive, periods of capacity production occurred each year. During this period, nearly 26,000 new gas wells were put on production but the state of Texas lost one trillion cubic feet in annual delivery capacity. But before we discount the importance of the five hundred percent increase in the number of gas well completions over a five-year period compared with a decade earlier, which nevertheless failed to offset the declining delivery capacity, it should be recognized that nearly one-half of the 1981 production came from these recently completed wells and, as the chart reveals, forty percent for the period 1978 through 1981. The 1978 surge in gas well completions was in anticipation of NGPA and subsequent years as a result of NGPA.

Again, referring to the chart, the much "touted" gas bubble which I fear is causing undue complacency, is represented by the shaded area between the total capacity line and total production line. In my judgement, at least this amount of annual surplus is necessary to meet the fluctuating, temperature sensitive, essential human needs of domestic consumers.

The dashed lines on the chart represent projections for future total available supply from all gas wells completed prior to 1982. This amounts to 2.815 trillion cubic feet. To round it off on the generous side and for ease of memory, Texas, which produced 7.5 trillion cubic feet of gas in 1972, will only be able to produce approximately 3 trillion cubic feet from wells producing since prior to the beginning of 1982. I have made no projections for future production from 1982 wells because they were completed at various times during the year, and have not been on production long enough to establish a reliable measure of decline. Others, using the same raw data, may project future declines differently but the inevitable conclusion is essentially the same.

Similar studies with which I am familiar but have not personally performed, project similar declines for gas delivery capacity for the entire nation and predict within a few years (by 1986) that approximately one-half of the nation's gas must come from wells which have not yet been drilled.

This statement on declining gas supply and the accompanying chart constitutes the essence of my testimony. But a few other comments should be made. The proposed bill authorizes the exchange of gas between companies with surplus supply and those with inadequate supply. This is already being accomplished in Texas through the Voluntary Gas Allocation Committee, which I have chaired for several years. Gas companies which compete vigorously at other times voluntarily cut off their large electric utility and industrial customers during peak demand periods and divert this gas to other companies, which need it to meet essential human needs. In the winter of 1973, we Texans almost "froze in the dark." On many occasions since then, there have been peak demand periods requiring maximum gas production, maximum withdrawl from storage, curtailment of industry with alternate fuel capability and voluntary diversion to those companies in greatest need. But on no occasion have we failed to supply essential human needs. I would commend this voluntary allocation procedure to other states and to the nation. Two observations are made: (1) There is a valid basis for the estimates of total gas availability based on periods of maximum production. (2) Although we have thus far avoided failure to meet essential human need, it is disturbing to contemplate any less surplus than now exists.

As a consumer consultant, I have long been gravely concerned over the take-or-pay provisions existent in most contracts. But the Railroad Commission gas proration orders and statesmanship on the part of most producers, have thus far protected consumers from payment for gas not taken. In my judgement, ratable take orders by the various states and "persuasion" by FERC is a better means of correcting take-or-pay provisions than legislative abrogation of contracts.

Although recognizing the immense expense of exploring for and developing gas below 15,000 feet, I have long contended that it was unsound to pay more for such decontrolled gas than the market clearing price. But market-out clauses and renegotiation of contracts have now largely corrected this maladjustment in price.

Congress recognized and producers have clearly proven with much technical data and testimony, that the immense reserves existent in the "107 tight formations" can not be developed without an incentive price. The price approved by FERC is believed necessary for development and approximately equal to the market clearing price. However, it is pointed out that this is a ceiling price, not a floor and that FERC, under existing authority, can change the ceiling. No legislation is therefore needed relative to "tight formations" and apparently, this fact is recognized in the bill.

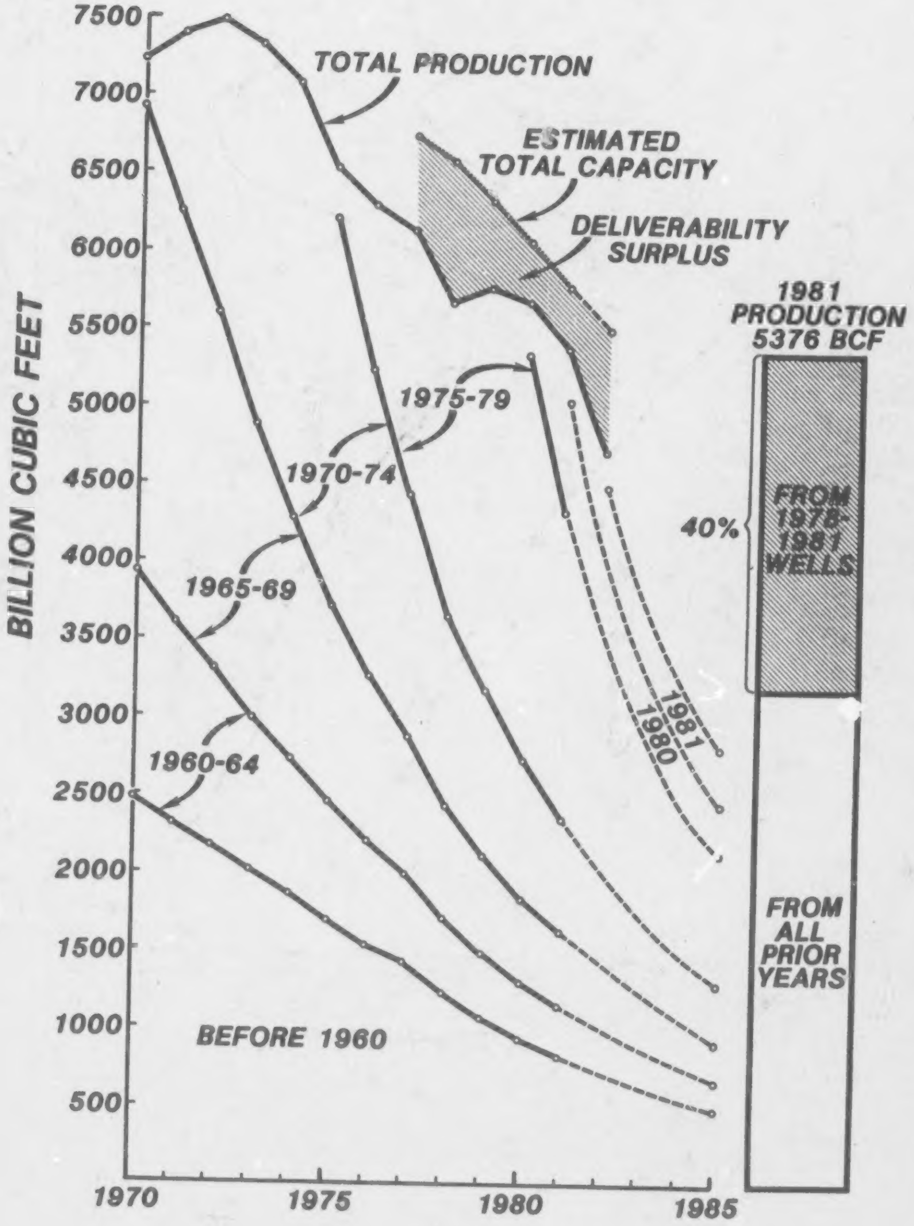
However, it does not seem reasonable to freeze the "tight formation" price, currently two hundred percent of Section 103, but at the same time roll back and, perhaps, continuously reduce the price for 102 (newly discovered gas) and even 103 gas. These two categories, in my judgement, constitute the best hope to the consumer for future reserves and improved deliverability at the most reasonable price.

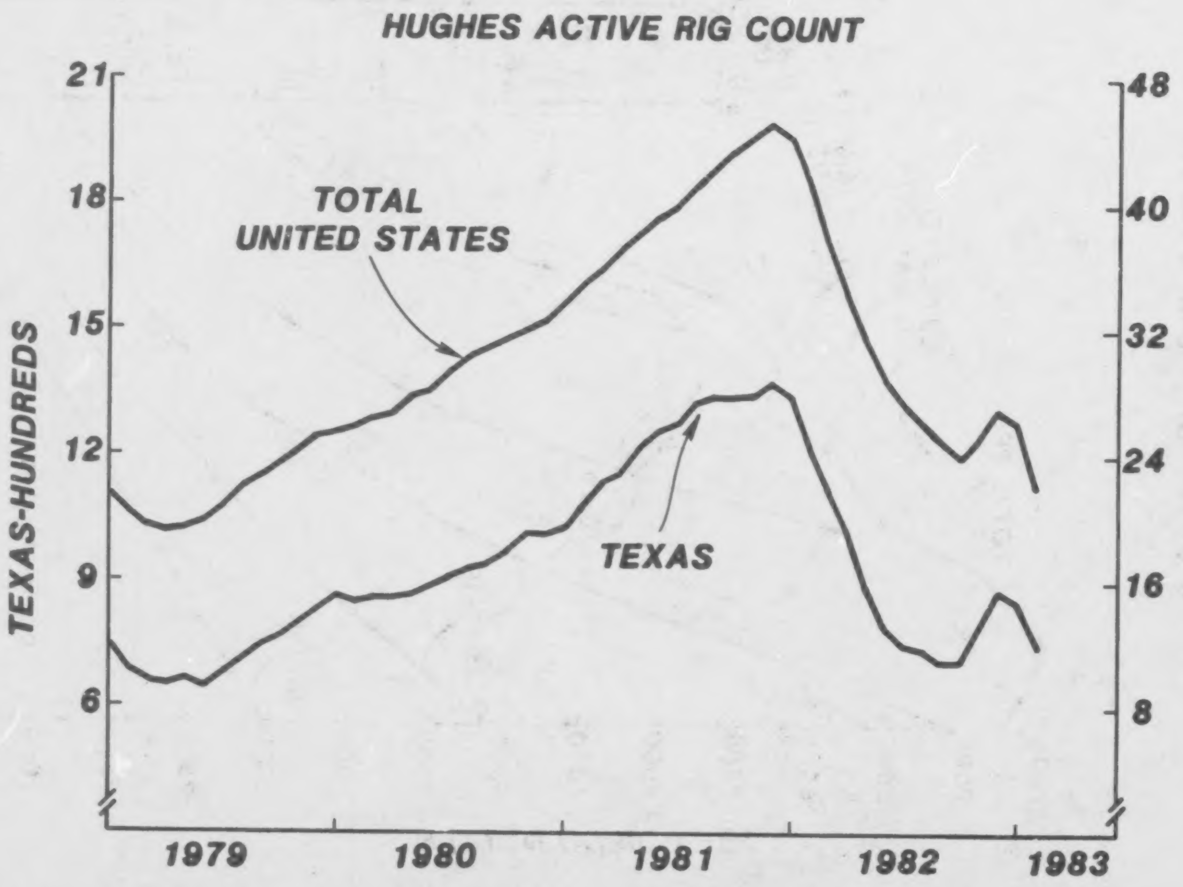
Finally, it would at first appear beneficial to my domestic consumer clients to require pipelines to transport gas for us if we can find cheap 104 gas, which has been released from contracts as a result of the bill. But, I am fearful that the successful bidders for this gas will be the industries and utilities, which will offer a uniform load factor as contrasted to the widely fluctuating, temperature sensitive, domestic consumer demand.

There was much criticism of the proposed NGPA during the many months of debate but it represented the best compromise which Congress could then reach. On the whole, NGPA has worked reasonably well and the fact that both interstate and intrastate now possess surpluses, even though I fear temporarily, is, in part, a tribute to NGPA.

Independent producers who historically have done most of the nation's exploration for oil and natural gas have learned to live with the NGPA but are now in great uncertainty over this new bill simply because it changes the rules. They are waiting for the other shoe to drop before continuing exploration, as evidenced by the sharp decline in the active rig count.

TEXAS GAS WELL PRODUCTION BY YEAR OF COMPLETION





HUGHES ACTIVE RIG COUNT

The CHAIRMAN. Dr. Thompson.

STATEMENT OF DR. RUSSELL G. THOMPSON, PRESIDENT, OPERATIONAL ECONOMICS, INC.

Dr. THOMPSON. I am Russell G. Thompson. I am president of Operational Economics, Inc., which is a Houston-based economics consulting firm, and we have had many years of experience in specializing in all facets of energy supplies, demands, and prices, and looking at these things in a very indepth, mathematical, and computer way.

Today, we have a kind of a Big Mac portfolio; we have a model in which it is fast and it is cheap to cover the energy sector of the United States. We are currently providing solutions to subscribers on a 48-hour, turnaround basis, and they can have the whole model to look at if they want to pay for it. A modest price.

Under the NGPA, what do we have for the basis?

Well, we had a basis that continued to be quite high rates of inflation; all prices would continue to go up; and deep prices would be an insignificant part of the cost paid by the consumer.

Basically, all those premises today are false.

Our results show from the modeling that the act is basically a regulatory pickpocket. It is picking a little bit of everybody's pockets, every consumer's pockets every day.

Our prices, the cost of the consumer, would be less without the regulations than with them.

Why is that? Well, because basically the act results—the NGPA results—in a distortion of the cost relationships, which represent the producers' cost curves and what he responds to, and also it creates a big discontinuity in the supply function of the representative producer, so when the demand curve falls in that discontinuity as it did in 1982, the bottom falls out of the prices, the deep gas prices.

And when it expands out of that discontinuity, as it did in 1980 and 1981, prices go through the roof; and these prices, then they get rolled in at the margin into what the average cost to the consumer, and lo and behold, the analytics clearly show, which is supported by all of the modeling, that we have the average cost scheduled to the consumer being above the incremental cost schedule in a market where you have a nonreplenishable resource.

And so we have, as far as an airplane analogy, we have a plane that is flying upside down, and further we have a racing of the engines.

So, how do we get the plane flying right-side up, and the engines stabilized? Well, the Reagan proposal is an effort to come to grips with the problem. Now, there are some short-term gains, as table 1 in our proposal, in which we have the prices that would result under business as usual, continuation of the NGPA from now through 1990, and you will notice that they are very close to what the American Gas Association has gotten.

We have the Reagan proposal. It gives short-term gains, in terms of the prices; but it gives long-term problems. Significant instabilities arise in the late 1980's, and it is virtually impossible for the model to balance supplies and demands.

Early deregulation—you get prices—they go down—immediately they go down, and then there would be an adjustment back and they would go up less without the regulation than with the regulation.

As far as oil prices in this table that I have, the oil prices are between $26.43 at the low end in 1982 dollars and up to $28.44 on the high end.

So that is what the oil prices are over the period from 1982 to 1990. You might be questioning a little bit about the initial prices for natural gas in 1982. I would be glad to provide an explanation for that, if that is so desired.

In conclusion, I would say the Reagan proposal is biased toward the here and now. There are some long-term feasibility questions, as the bill now stands, with regard to the ability of the supplies and demands to balance in any reasonable way toward the end of the decade. The reason being, as pointed out by Mr. Palmer, the incentive is not going to be there for drilling, so the reserve additions won't be coming forth, and so you are going to have less production and that is what is really needed to keeping the pipelines in order to have orderly markets.

And so that does cause—and with demand additions, especially with the modest rates of growth in the economy, that gives rise to problems at the end of the decade because, what happens to the new consumer, the new householder, the new office occupier, the new small business—here do they get gas? They probably will have to go to an alternative fuel; electricity or fuel oil.

The CHAIRMAN. Thank you very much, Dr. Thompson. I appreciate your testimony.

[The prepared statement of Dr. Thompson follows:]

REVISED 3/15/83

OPCON

Operational Economics, Inc.
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Testimony of Dr. Russell G. Thompson
In Senate Hearings on Natural Gas Price Deregulation,
U.S. Senate Committee on Energy and Natural Resources
Senator James A. McClure, Chairman
Senate Dirksen Building, Room 366, Washington, D.C.
Saturday, March 12, 1983

Distinguished Senators, I am Dr. Russell G. Thompson, president of Operational Economics, Inc. (OPCON). OPCON is a Texas-chartered economics consulting firm. (We are located at 802 W. Alabama, Houston, Texas, 77006, Phone 713/528-3158.) It has in-depth expertise in all facets of energy economics. (Brief Statement of Capabilities and Biographical Summary will be provided in the Addendum.)

The basis for my testimony today is not only my expertise in energy economics, but also OPCON's energy models. These models took 10 years to build at an investment cost of 100 professional person-years and approximately $5 million. OPCON's Fuels Forecasting Model is sound and transparent in structure; it is user-friendly and inexpensive to use. This Model is made available to clients on a subscription or special study basis. We are providing solutions to clients within 48 hours.

In our many evaluations of natural gas pricing issues, the following highlights are relevant to your deliberations:

- The Natural Gas Policy Act (NGPA) has increased significantly the costs of gas to the representative consumer in contrast to what these costs would be if prices, which are to be deregulated in 1985 (e.g., Section 102 gas), were deregulated today. Further, not only would gas prices to the consumer immediately fall with early deregulation, but gas prices would rise less in the long run without these regulations than with them. Economically, these counter-intuitive cost relationships result from the fact that the NGPA has inverted the cost schedules of supplying gas to consumers. No longer are incremental costs above average costs because the deep, high-cost gas has become such a large part of the base, around 20% of the price paid by the consumer. Average costs with the regulations are now greater than incremental costs without the regulations. Hence, removing the regulations would result in an immediate price decrease, not increase.

- In addition to being a legislated pickpocket of virtually every gas consumer, the NGPA has created great price instability in the gas market where none existed before the Act and where none would exist after early deregulation. This price instability is causing major misallocations of resources among virtually all producers of gas and their suppliers, as well as among virtually all consumers of gas--

residential, commercial, industrial and electric utilities. Economically, this price instability arises because the NGPA created a discontinuity in the representative producer's supply schedule. Anytime the demand contracts enough to fall in this discontinuity, as in 1982, the bottom falls out of the high-cost, deep gas prices; and anytime the demand expands enough to rise out of this discontinuity, as in 1980, the high-cost, deep gas prices go through the roof.

- The distortions in costs and instabilities of prices caused by the NGPA generally work against consumers buying from pipeline companies with a relatively large base of newly found reserves and work in favor of consumers buying from pipeline companies with a relatively large base of old reserves because the deep, hard-to-find gas prices vary the most as a result of the distortions and instabilities. Accordingly, effects of this legislated bias damage one group of consumers at the gain of another, neither of whom did anything to warrant the damage or the benefit

- The effects of the distortions in costs and instability of the prices caused by the NGPA not only ripple throughout all producers and consumers in a given year, but because of the investment fixity involved, they ripple throughout the economy for many years down the road. For example, the NGPA is distorting the amounts and types of reserve additions; and it is distorting the types and levels of fuel-using investments being made by consumers.

Following logic, any proposal to roll back prices and freeze them at any previous historical level would work away from, not towards rectification of the problem. All of the distortions in costs and instabilities in prices would be masked by the freeze and the hidden costs of this masking would spill over into the markets of other fuels, thereby increasing crude oil imports and electricity use, both of which are higher-cost fuels. Fuel consumers who do not have "endowed rights" for additional gas as demand expands with economic growth will be forced to pay these higher alternative fuel costs not because of any necessary economic shortage of gas, but because of a legislation-induced shortage of gas.

As legislated, the NGPA does not generally serve the public interest of either producers or consumers. A simple, logical and equitable solution to much of the problem is to accelerate the deregulation of gas, especially Section 102 gas, as fast as possible. This action would work toward immediate elimination of the distortion in the cost relationships and the instability in market prices. In a pilot's language, the airplane would then be flying right-side-up and the power source would be stablized. This rectification is necessary before the Congress and the Administration can make any progress toward efficiency and equity in natural gas pricing.

More specifically, OPCON has modeled three cases: (1) Business-As-Usual (BAU) Case following the NGPA, (2) Early Deregulation (Early Dereg.) of Natural Gas Prices Under NGPA, and (3) the Reagan Proposal Case. As proposed, the Reagan Case would provide consumer protection through elimination of automatic pass through of price increases by pipelines, free the parties to negotiate new contracts and eliminate disincentives for use of new gas; it proposes to deregulate all gas with a cap on the average price of gas to the consumer. As modeled by OPCON, gas prices to the consumer were not allowed to rise more than 6-1/2% per year in real terms.

The average wellhead prices for natural gas (in constant 1982 dollars) are shown in Table 1 for all three cases, as well as for comparison purposes the published projections of the American Gas Association (AGA). In the BAU Case, our price projections are slightly below those of the AGA in years 1982 through 1986 and are slightly above them after that in years 1987 and 1988. Our gas production, fuel use, end-use prices, and oil imports have much in common with previous reports to Congress by the Energy Information Administration, except we generally obtain less of a fly-up at the time of gas price deregulation than EIA does.

In the Early Deregulation Case, relative to the BAU Case, the natural gas prices are the same in 1983 and are less in years 1984 through 1990. It is noteworthy that the increase in prices is only 23 cents per million Btu in the Early Dereg. Case from 1982 to 1983, yet the increase in prices is 60 cents per million Btu in the BAU Case from 1984 to 1985. This highlights the importance of deregulating prices in a recessionary rather than in a growth period for the economy.

The Reagan Case, as modeled, holds down the gas price between 1983 and 1988 at a significant hidden expense in reserve additions and later insufficiency of supply capability to meet demand growth. In fact, the hidden expense of the gas price cap becomes so great in 1989 and 1990 that OPCON's Model has terrible difficulty in balancing supplies and demands. That is, the Reagan Case provides short-term easement of gas price increases at the expense of great price instability and major disturbances at the end of the 1980's. As all efforts to hold down prices, the Reagan Case is biased in favor of the here-and-now at the expense of the future; for example, new homeowners, new small business, new factories and new offices.

The significance of the bias against exploration/development drilling in the Reagan Case is highlighted by the projections of Sections 102 and 107 prices in Figure 1. Increases in Section 102 prices in the BAU and Early Dereg. Cases would increase drilling and reserve additions for this type of gas; however, the projected price path in the Reagan Case falls far below the projected paths in the two NGPA cases. Moreover, the Section 107 prices in the Reagan Case are far below those prices in the BAU Case. Natural gas reserve additions in response to prices will be much higher under the NGPA than under the Reagan initiative.

In conclusion, the solution to the natural gas pricing problem is to revise the NGPA. Immediate deregulation of Section 102 gas prices is needed. This will work toward normalizing the level and stability of costs paid by consumers. It will further force the gas utilities to become economic buyers and sellers of gas. Sufficient surpluses will then exist to take care of the welfare problems created by the deregulation in a meaningful way, as a separate issue, which it should be.

Table 1. Comparison of Outlooks for Average U.S. Natural Gas Prices at the Wellhead, 1982 Dollars/MMBTU

		OPCON			
	Am. Gas Assoc.*	Oil Price $/bbl. in '82$	NGPA Business-As-Usual	Reagan Proposal	NGPA Early Dereg. in '83
1982	2.46	31.60	2.22†	2.22†	2.22†
1983	2.64	27.80	2.45	2.22	2.45
1984	2.80	26.40	2.74	2.40	2.70
1985	3.90	26.70	3.34	2.48	3.20
1986	3.78	27.40	3.71	2.66	3.55
1987	3.64	27.60	3.74	2.85	3.61
1988	3.52	28.00	3.88	3.06	3.78
1989	NA	28.20	4.23	Unstable	4.16
1990	NA	28.40	4.72	Unstable	4.66

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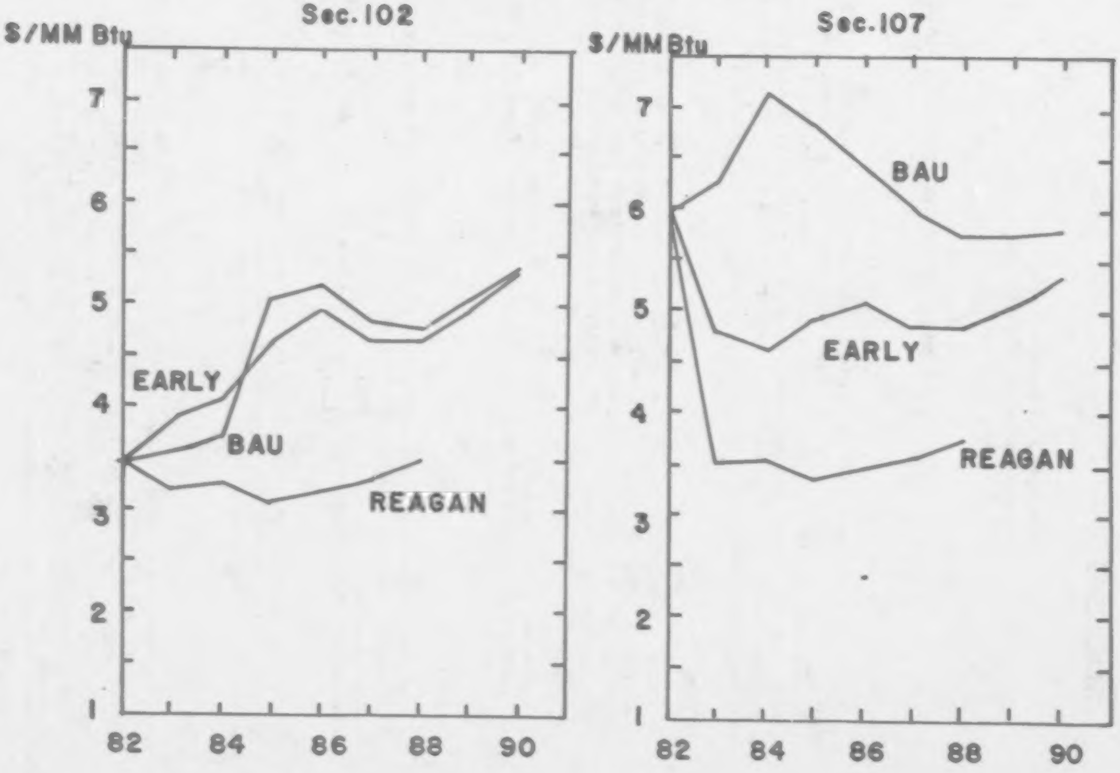
*Oil & Gas Journal, September 20, 1982, p. 76.

†1982 price statistics readjusted downward because the model does not account for stripper gas and processing pass-throughs.

FIGURE 1

OPCON's Projected Wellhead Natural Gas Prices --
Sections 102 and 107, 1982 Dollars


Sec. 102

Sec. 107

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BRIEF STATEMENT OF CAPABILITIES

Who we are

OPCON is a Houston-based economic consulting firm. It was founded in 1979 by Dr. Russell G. Thompson as a Texas for-profit corporation. Dr. Thompson is also the chief executive officer of the firm. The company brings together a group of experienced economists, engineers, and mathematicians. The group is internationally known for integrating engineering practice into economic analysis. This integration is called operational economics.

What we do

OPCON's expertise is in operational economics. We do economic analysis and forecasting. We have data and mathematical models. We publish a newsletter, "Economic Insights." We design and develop customized management information systems. We provide expert testimony. Our services are available to clients on a time and materials, fixed price contract, annual subscription, or negotiated fee basis.

Currently, OPCON offers services in the following areas: Fuel Prices, Drilling Economics, Energy Demands, Oil/Gas Supplies, Chemical Economics, World Oil Trade, Environmental Costs, Economic Impacts.

How we do it

OPCON's operational economic method links everything that can be known about the future with everything that is discernible from the past. Its common threads are mathematical modeling, data gathering, engineering analysis and economic evaluation. We consider not only how persons have coped, but how they can cope in a world of increasing uncertainty.

OPCON's systems are designed to allow for flexibility in examination of economic concerns with respect to changes in supplies, demands and prices. Systems are continually being updated to give credible, up-to-date forecasts.

Our clients

Our clients can benefit from our individual and combined capabilities as well as from our unique methodology. They will obtain a detailed presentation of their situation, taking into account the critical factors in decision making (e.g., in deciding whether to expand production or to start with a new product). They will also get far-reaching insights as to how new trends may develop in the firm, in the industry, and in the general economy. OPCON's system of analysis and resolution will provide our clients with the information which will answer their company's needs and direct it toward a more profitable future.

Basically, clients obtain the necessary inputs needed for profitable decision-making at the highest levels.

OPCON's clients include the following organizations:

- AMF Tuboscope, Inc.
- Brown & Root, Inc.
- Chicago Mercantile Exchange
- Continental-Emsco Company
- Convest Securities Distributors, Inc.
- Eckel Manufacturing Company
- Electric Power Research Institute
- Exxon Company, U.S.A.
- Federal Energy Administration
- FMC Corporation, Fluid Control Div.
- GCO Drilling Company
- John E. Gray Institute
- Gray Tool Company
- Houston Guardian Trust Company
- Houston Lighting and Power Company
- Hydril Company
- Japanese Government
- National Science Foundation
- Newconex Corporation
- Oak Ridge National Laboratories
- Poten and Partners, Inc.
- Republic of Texas Coal Company/ Mitchell Energy Joint Venture
- South Texas Drilling and Exploration
- State Boat Corporation
- U.S. Department of Commerce

OPCON's staff

OPCON's staff has worked together for many years under the leadership of Dr. Russell G. Thompson to solve firms' problems. This well-founded accumulation of expertise allows OPCON to identify the central problems of significance and to find ways to resolve those problems. Both apt combinations of practical knowledge and conceptual frameworks are used in resolution. In addition, OPCON's staff has held a wide range of responsible positions in the academic world and in national and international organizations.

Dr. Thompson has published many journal articles, edited numerous technical monographs, held the position of consultant for numerous organizations, and provided expert testimony to the U.S. Congress and the Texas State Legislature. He has been a tenured professor at several leading universities. Dr. Thompson has a Ph.D. from the University of Minnesota.

OPCON's other key personnel are as follows:

C. J. Kehoe - Administration/Finance
K. R. Khosravian - Policy Analysis
J. P. Leigh - Contract Procurement
J. Llewellyn - Space Scientist
P. A. Orleans - General Counsel
F. D. Singleton, Jr. - Systems and Engineering Analysis
J. C. Stone - Mathematical Modeling
R. M. Thrall - Operations Research

Offices

In addition to the letterhead office, OPCON has Golden Triangle Offices at 3965 Phelan Blvd., Suite 206, Beaumont, TX 77706, telephone (713) 833-1859); and 4925 Gulfway Drive, P.O. Box 2368, Port Arthur, TX 77640; telephone (713) 985-5596 or (713) 727-3554.

BIOGRAPHICAL SUMMARIES OF KEY PERSONNEL

Russell G. Thompson
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Houston, Texas 77006
(713) 528-3158

Experience:

- Chairman of the Board, President and Chief Executive Officer of Operational Economics, Inc. (OPCOM), since June 1, 1980.
- Tenured professor of Quantitative Management Science at University of Houston since September, 1971; previous tenured faculty appointments at Texas A&M University (1967-1971) and University of Missouri (1962-1967).
- Visiting Professor in Applied Mathematics and Physics at Kyoto University, Kyoto, Japan, summer 1975; and Visiting Scholar at International Institute for Applied Systems Analysis, Laxenburg, Austria, summer 1977.
- Principal Investigator of more than 10 major contracts (or grants) at University of Houston.
- Consultant activities include industrial firms, electric utilities, U.S. Government, Japanese Government, Texas State Government, several National Laboratories, Electric Power Research Institute and several National Commissions.

Education:

- Ph.D. in agricultural economics with minor in statistics from University of Minnesota in 1962.
- National Science Foundation Science-Faculty post-doctoral fellowship study in mathematics at Purdue University, 1965/1966.

Publications:

- Numerous articles in leading referred journals. Illustrative examples are as follows:

  "Refinements in Energy Economic Modeling for Policy Purposes." *Computers and Operations Research*, Vol. 9, 1982, CAOR-67, pp 1-24, with J. C. Stone, S. Muthukrishnan and A. N. Halter.

  "High Prices Will Dampen Industry's Demand for Gas." *Review of Regional Economics and Business*, April, 1982, pp. 9-15, with F. D. Singleton, Jr., John C. Stone and E. R. Khosravian.

  "Verification/Validation of an Economic Process Model for Electric Power Generation in the United States," *Computers and Operations Research*, Fall, 1981, pp CAOR12-1 through 12-29, with F.D. Singleton,Jr. and S. Muthukrishnan.

"Forecasting Structural Change in Industry and the Economy with Resource Restrictions," *Interdisciplinary Science Review*, Vol. 1, No. 4, Dec. 1976, pp. 311-321. Co-authored with R. J. Lievano and J. A. Calloway.

"Environment, Energy, and Capital in the Fossil-Fueled Electric Power Industry," *Computers and Operations Research: An International Journal*, Vol. 3, No. 2-3, Aug. 1976, pp. CAOR 8711-8717. Co-authored with L. T. Moore, R. J. Lievano, J. A. Calloway, H. P. Young, and L. A. Nawalanic.

"An Integrated Economic Model of Petroleum Refining, Electric Power, and Chemicals Industries for Costing Pollution Control and Estimating Energy Prices," *Engineering and Process Economics*, Vol. I, 1976, with J. A. Calloway.

"Forecasting Water Use for Policy-Making: A Review," *Water Resources Research*, Vol. 9, Aug. 1973, with H. P. Young.

"A Stochastic Investment Model for a Survival-Conscious Firm Applied to Shrimp Fishing," *Applied Economics*, Vol. 5, June 1973, with M. D. George *et al*.

"A Nonconvex Model of the Firm," *Econometrica*, Vol. 39, Sept. 1971, with R. R. Hocking and M. D. George.

"Optimal Production and Investment Controls for the Firm," *Management Science*, Vol. 15, Sept. 1968, with M. D. George.

"Demand, Supply, and Price Relationships for the Beef Sector, Post World War II Period," *J. of Farm Economics*, Vol. 49, Feb. 1967, with L. Langemeier.

"The Economic Value of Translating Weather Information into Operational Terms," *Monthly Weather Review*, Vol. 94, Feb. 1966, with J. D. McQuigg.

- Four book-length monographs published by Gulf Publishing Company, Houston:
    - *Cost of Clean Water*, 1976, lead editor and co-author of all chapters.
    - *Cost of Electricity*, 1977, lead editor and co-author of all chapters.
    - *Cost of Energy and A Clean Environment*, 1978, lead editor and co-author of almost all chapters.
    - *An Economic Model-New Oil and Gas Supplies in Lower 48 States*, 1978, with Y. Y. Kim.
- Over fifty technical reports to leading government, foundation, and industry representatives. Edited with others five book-length monographs with others.

The **Chairman**. Mr. Moorhead, on page 17 of your statement, you make reference to the—well, I will just read what the statement says.

> It seems to make little economic sense to have domestic supplies of gas in California shut-in with "takes" as low as 20 percent of deliverability while purchases are made by California utilities at the Canadian border for gas which, when delivered, costs nearly twice as much

Mr. Moorhead, is that a significant volume that is available?

Mr. **Moorhead**. Is the 80 percent that we are not producing a significant volume, is that——

The **Chairman**. Yes.

Mr. **Moorhead**. I do not have those numbers in mind, and I can refer to one of my associates back here.

The **Chairman**. If it is readily available, we will accept it now; if you need to supply it for the record, we will take it when you can furnish it.

Mr. **Moorhead**. Let us furnish that data.

The **Chairman**. If you would, please.

Because it may be such a volume that it is a significant demonstration of the problems of the market today. It may be of such an insignificant volume that it really doesn't bear much on the question.

Let me ask a general question, perhaps to you, Mr. Mut, and to Mr. Moorhead, in particular, but others of the panel too if they wish to answer.

It has been suggested that integrated oil companies, those oil companies that have both oil and gas production in significant volume will have a disproportionate capability to withhold supplies of gas from the market in order to wait until price controls are off and then sell at a higher price.

If that a significant possibility?

Mr. Mut?

Mr. **Mut**. Not in our company. We did have a rueful smile when we heard those statements.

As you know, oil prices are dropping; our income from that source is dropping.

Gas demand is down so that our income from that source is dropping; we do not have this vast treasury of untapped dollars to draw upon. We too are heavily borrowed. No, we can't do that in any appreciable measure, and wouldn't intend to.

The **Chairman**. Mr. Moorhead.

Mr. **Moorhead**. Certainly, the independent producer, and I think we are not atypical in this respect, must have cash flow; and that precludes the opportunity to shut something in.

As I indicated in my opening remarks, we will be out seeking to renegotiate contracts the minute this becomes law, to get the cash flow.

The **Chairman**. Mr. Murray.

Mr. **Murray**. Sir, that has been a big myth for many years, that people just don't know the competitive nature of the oil and gas business.

One thing a producer will not stand. He will give his gas away or almost flare it, which, as a conservationist. I have been appalled about rather than let the offset operator drain it; so, unless you own the whole field you can't shut it in and wait.

Exxon owned the King Ranch and did wait for better prices of gas, and then they marked, committed it, and they think they didn't wait long enough.

But that is one of the few examples and I can't fault Exxon because if that gas is very much needed today that they didn't produce way back there because they added oil and it wouldn't be drained.

But typically, it is drainage that keeps you waiting for the future.

The CHAIRMAN. Mr. Murray, you said that you were the author of the prorate reduction plan by the Texas Railroad Commission; is that something that we ought to apply on a nationwide basis?

Mr. MURRAY. In my judgment, yes. Now, let me acknowledge, I am kind of a born-again proration guy, and we were doing it long before they thought about putting take-or-pay in the contracts.

Not too many years ago—now, I am an ex-railroad commissioner and a consultant to the cities of Austin and San Antonio, and we have got these billions of dollars of take-or-pay, not all against us, accruing, and the government of Texas asked me about calling a special session of the legislature to outlaw take-or-pay.

And I replied, "Let's don't do it if we can avoid it."

For the reasons that Senator Metzenbaum stated better than I could state. I just hated to—but by prorating, yes.

There ain't no way—excuse my language—how can you claim payments for gas you didn't have the legal right to produce?

And so, when we set an allowable equal to the demand, we were then able to go around and settle the take-or-pay claims, because pretty soon the lawyers were only paying the lesser of their DCQ, their contract quantity, or their commission allowable.

Now, I think the principle is sound. I acknowledge that at times the method has not been fine tuned as well as it should. One description of mine was that it is kind of like setting a 150-mile speed limit, and say, "No violators."

And we have had allowables too high, and I am probably going to chair a committee that will be asked by the railroad commission to make a report on what we need to do to fine tune it; but I do strongly advocate, believe the system of ratable take encourages development in times of surplus because every independent producer knows he will get a share of the market, not just the big ones that can negotiate for it.

I think it assures fairness, nonwaste, nondrainage, equity, and it stops the take-or-pay claims.

The CHAIRMAN. Several witnesses have suggested that if we open up the entire national market to competition, the competitive forces will keep prices lower; but several have suggested that in order to truly open the national market, there has to be an access to the distribution facilities, the transportation facilities that may not exist under current regulatory regime; that in order to match up suppliers and consumers the links inbetween must be available and open on some predictable basis.

Mr. Mut, do you perceive a problem in that area if we don't deal with the question of the access to pipelines?

Mr. MUT. No, sir. I really don't. There are places where access to pipelines is a problem, particularly in areas where there has been little earlier gas activity and the pipeline network is not really well developed and in place.

But the pipelines do serve a very fine purpose in smoothing out the demands of the marketplace, working with the supply. I find it hard to conceive of an orderly system in which the situation was grossly different from the way it is arranged today.

The CHAIRMAN. Mr. Palmer.

Mr. PALMER. No, sir, I have no comment on that.

The CHAIRMAN. Mr. Moorhead.

Mr. MOORHEAD. Yes, sir.

I know I have no real expertise in the area of pipeline operation, but it is clear to me that without freer access than I have perceived to exist to the transportation network of natural gas, one of the administration's stated objectives to create a true national market cannot be obtained because we might approach, which I think would add richness and diversity in this market—we might approach industrial users in the East and find an interest and strike a price, and yet be absolutely unable to move gas to that industrial user because they—it makes no difference if it is an industrial user or a municipality, or whatever because if you could get it through the pipeline, as I understand the new proposed legislation, but we couldn't get it through the intervening links, so as a practical matter the market will continue to be quite heavily regionalized, localized, without further access to the transportation system.

The CHAIRMAN. Mr. Murray, do you think that is a problem?

Mr. MURRAY. The equal access or the common carrier status is something that I have wrestled with for a good many years. I have had actual experience in Texas. We didn't need legislation. In my book we persuaded the pipelines to carry gas for us, and then finding that owning our own supplies, contracting with the producer wasn't quite as good as we thought it was going to be.

The CHAIRMAN. Didn't the Texas Railroad Commission have a little bit more clout with those pipelines than a single producer or a single consumer?

Mr. MURRAY. I missed your question, sir.

The CHAIRMAN. Well, you said you were able to persuade the pipelines—didn't the railroad commission have a little bit more ability to persuade than a single producer or a single consumer would have had?

Mr. MURRAY. Back when I was a railroad commissioner—or the commission now, it has a good bit of authority, sir, but now I am talking about, I have bought gas for my clients—Austin and San Antonio, and while I didn't work for pay for LCRA, we put them together, because I didn't want the three of them competing with each other; and we got a good package of gas and we were getting it hauled for them.

Then, the railroad commission says, "do you expect to stay warm with every other city doing without just because you bought your own gas?"

And that didn't seem reasonable, and I realized it wasn't any great advantage of us having our own gas when we were going to have to share it, so I turned our gas loose, and put it into the system for everybody.

Plus, we were the ones responsible for take-or-pay.

Now, the San Antonio load, for example, ranges from 70 million a day to 400 million a day, and I am out right now—I have got new bosses; you see the city council changes and they kind of have to relearn, and they say: "Go out and get some of this cheap gas."

And I don't find anybody who wants to sell me any cheap gas with that varying load; and when I get to going after it, it is the industry that is going to take it regular the year-round that is going to buy the gas.

And then I get a little worried because we have a priority system in Texas, and the FPC does too, and the domestic consumer is top on the priority, no matter if you are getting—all the other industries are cut off, and we are the last to be cut off, but if everybody has bought their own gas, are we going to be able to grab their gas back from them, so it isn't quite as much a desired thing as it starts out seeming to be.

The CHAIRMAN. Dr. Thompson, do you have a comment?

Dr. THOMPSON. I pass.

The CHAIRMAN. Thank you very much. Senator Ford?

Senator FORD. The chairman has been very thorough in his questioning. Let me ask Mr. Murray this question. If you nationalize proration, what does that do to the State's ability to prorate?

How would it damage a State's ability?

Mr. MURRAY. I think it would interfere, sir, and that is something we debated a long time. Way back there you may recall my colleague, the great General Thompson, chairman of the railroad commission many years back, said a little Federal control was like being a little bit pregnant, and I happen to think that it is better for each of the States to do their own proration than for the Federal Government to do it.

But as a conservation engineer, particularly when I was working for the Federal Government, I wasn't too sure but what in my impatience I would rather the Federal Government go ahead and do it right now than wait.

But my judgment is it would be much better for the States to do that and have the Federal Government only come in on Federal lands like OCS and the appropriate agency there require ratable take on the OCS.

Senator FORD. Do you see anything in this legislation that would otherwise interfere with a State's ability to prorate?

Mr. MURRAY. I saw something, sir, but I am not legally trained, and a lot of good lawyers are confused about what this legislation says.

For one thing, it says you are required to take in proportion to deliverability. Who is going to establish that deliverability.

And I do see some indications here where this bill would supersede the authority of the States to require ratable take.

Senator FORD. Well, let me ask you this. Does the affiliated entities production limitations bill interfere?

Mr. MURRAY. I don't believe I would be qualified.

Senator FORD. Could your counsel answer that?

Mr. **Forgotson**. Senator, it might interfere because of the fact if you were required to cut back on your affiliates if there is other cheaper gas available, it could interfere.

I think we have to see it—because you get into these drainage problems and how you equalize them, et cetera.

So I think that is something that hasn't been given full consideration. The other clients that I work with had some great reservations about that had it been applicable to intrastate pipelines, which we understand is not the oase in the bill right now.

But it could create a problem because still the majority of the purchases in Texas and in Louisiana I think are made by interstate pipelines.

And you have to apply that across—the proration across the board.

Senator **Ford**. Of course, you just made another distinction between interstate and intrastate, but you said it wasn't applicable to intrastate, so we keep finding that thread, Mr. Chairman, in all of the interpretations of this legislation as it relates to intra and interstate pipelines.

Mr. **Murray**. Excuse me, Senator Ford, I may not have been sufficiently alert. When the Railroad Commission——

Senator **Ford**. For a man who only had 4 hours' sleep, I don't fault him for not being too alert.

Mr. **Murray**. When the Railroad Commission prorates, they don't ask whose wells are affiliates of whom; they just set the allowable because they have got to look after the royalty owners, too.

And I do not think there ought to be any difference you look at getting a fresh air or the production from a common reservoir.

Senator **Ford**. Dr. Thompson, let me ask you this. Are you saying in your testimony that NGPA is better than S. 615 as is?

Dr. **Thompson**. Well, the NGPA has serious problems. How long can you fly this airplane upside down with the engines racing?

Senator **Ford**. Yes, but we are at 40,000 feet now. You have flown that airplane upside down twice on me. All I want to know is if you compare NGPA as is and 615 as is, I understood your testimony or your statement to say NGPA was better.

Dr. **Thompson**. I would say—here is what needs to be done to NGPA.

Senator **Ford**. No, wait a minute. You smart fellows are getting this country boy all mixed up, and I want to try to keep you on a level field with me.

I was trained at Fort Hood, and I know every branch of Cowhouse Creek, and so I have been down there. All I want you to to do is to tell me is, in your opinion as the two pieces of legislation are there—one is in place and the other one is being proposed—is NGPA better than S. 615.

Dr. **Thompson**. Well, it is hard to respond to something in both cases that has got flaws.

Senator **Ford**. I understand that. I understand the flaws. Just which one is weighted the most in favor? Which one would you say is the best with the flaws?

Dr. **Thompson**. Well, if we can lock out the 85, the section 102 will be deregulated under NGPA——

Senator FORD. Let's don't knock out anything. Let's take the flaws as flaws and pluses as pluses and tell me which is best in your opinion.

I have read your statement, Mr. Thompson.

Dr. THOMPSON. Well, if you are saying we have got sufficient altitude, it will be a long time before we crash, in that case if you have got the altitude and it will be a long time before you crash, the NGPA is better.

Senator FORD. That is all I wanted to know. Mr. Chairman, I quit.

The CHAIRMAN. Senator Hecht.

Senator FORD. You know, the significant thing is, Mr. Chairman, that we have a fellow in Texas who tells us NGPA is better.

Dr. THOMPSON. Under your proviso that we are at high altitude.

Senator FORD. That is right. But you are the one that got us in that airplane.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Mr. Moorhead, in your testimony you mention that you have several hundred possible drills rated go. Are you waiting for deregulation?

Mr. MOORHEAD. No, sir, we are waiting for market and for certainty or further certainty as to the regulatory environment.

Senator HECHT. Are you in favor of this proposal to deregulate?

Mr. MOORHEAD. Yes, sir.

Senator HECHT. Since you have several hundred new rigs, what do you feel the price will be down the line with deregulation?

Mr. MOORHEAD. Let me clarify something.

Senator HECHT. OK.

Mr. MOORHEAD. We would be drilling several hundred more wells this year, additional wells, for moderate depth incremental supplies of natural gas if we had market for the gas and if we had some further regulatory certainty.

Senator HECHT. Keep talking. Keep talking. Go on.

Mr. MOORHEAD. Well, the price, we believe, would be slightly lower than today's prices, but still attractive in terms of providing a return on investment for those investments in additional wells.

Senator HECHT. Then obviously you feel that we are in the right direction—we would be in the right direction if we do accept the President's proposal to give you the chance to go out and you can produce wells at a market price less than the price is today?

Mr. MOORHEAD. Yes, sir.

Senator HECHT. Thank you very much.

The CHAIRMAN. Thank you. Senator Murkowski was unable to be here today. He asked that I propound two questions to you, Mr. Mut.

In your discussion beginning on page 8 of your testimony you say that decreased revenues caused by the cap rollback will have an adverse effect on drilling activities which could result in shortages and curtailments.

When do you foresee such shortages and curtailments occurring?

Mr. MUT. Mr. Chairman, we have made two attempts to get a prediction on that point, going at it from two entirely different ways.

One method that involved a correlation of gas finding rates with rig account and making projections into the future wound up with a rather surprising conclusion that we might have a shortage and curtailment as early as the winter of 1984 or 1985.

Now we also tackled the problem from another direction, making other assumptions about the marketplace, finding rates, et cetera, and come up with the conclusion that, as we see it, that might occur about a year later than that; that is, about the winter of 1985, 1986.

So that sort of is the time frame that we would anticipate getting into trouble unless we are able to pick up our exploratory activity very quickly.

The CHAIRMAN. On page 13 of your testimony, you state that you support the balanced approach of S. 615, although it contains bitter pills for the producer, such as roll-backs and reduced take or pay.

As to the pipelines option to reduce take or pay to 70 percent, what would the exercise of such option by all your purchasers cost your company?

Mr. MUT. We have taken a very hard look at that, Senator, because we have been in dialogue with all of our major gas suppliers, many of whom are in a take or pay difficulty and looking at exactly what various levels of take or pay limitations would do to our particular situation.

We have had 70 percent mentioned in the bill, 50 percent mentioned by several people here in the hearings. A 70 percent limitation for our company would reduce our revenues in a 1-year period to $192 million.

If we extended that limitation down to the 50 percent level, our calculation shows it would be a $415 million production in revenue.

The CHAIRMAN. Thank you very much. Senator Melcher?

Senator MELCHER. Mr. Moorhead, on page 17 of your testimony you made this point earlier referred to by the chairman that it seems to make little economic sense to have domestic supplies of gas in California shut in with takes as low as 20 percent of deliverability while purchases are made by California utilities at the Canadian border for gas which when delivered costs nearly twice as much.

What is there about this legislation as proposed by the administration that would have any bearing on the Canadian price of gas at the border?

Mr. MOORHEAD. The potential for a true national market would wipe out a great many of the little anomalous situations like this which are, to the best of my understanding, to no one's best interest.

The purchases—a great many of the purchases of foreign gas have been made in full good faith by the purchasers because the regulatory constrictions of existing and prior legislation gave them no alternative they could understand.

I think that is the history of this sort of a situation. We are now talking about the opportunity under the proposed legislation of a total restructuring and a nationalization instead of a regionalization or a regional structure of the market.

Senator MELCHER. Well, isn't it true that some or perhaps all of those contracts for Canadian gas are not—they are not subject to be cancelled by this legislation—by present law or this proposed legislation?

Mr. **Moorhead**. Sir, I am not knowledgeable as to the terms of those contracts.

Senator **Melcher**. Mr. Murray, you made a statement that reminded me of something.

You said there is one provision in the bill that you were a little bit uncertain about and thought might be not only confusing but could be interpreted in such a way that it could be detrimental.

So that reminded me of Murphy's law, first of all, that anything that can go wrong will go wrong. But secondly, it reminded me of my own law that anything not clear in Federal law will be followed by regulations that are wrong and worse from all sides.

Now what is that point that you find so confusing? I didn't understand from your remarks just what the point was.

Mr. **Moorhead**. Well, I apologize because sometimes, sir, that is spelled M-U-R-R-A-Y's Law, you know. I have had that experience, and I didn't purport to try to interpret the thing.

What is disturbing me is that skilled people are coming up with such terrifically different conclusions.

Senator **Melcher**. Yes. A good example is the gentleman to the left of your counsel there, Mr. Thompson, comes up with a conclusion that NGPA may produce higher prices than what the Reagan proposal will produce.

And I think it is fair to say that Secretary Hodel presented his testimony on behalf of the Reagan proposal as producing lower prices before the decade is out.

Mr. **Murray**. Senator, I make no claim to give as good a judgment of what the cap would be or what the price would be as the other people who spoke.

My main thrust is our supply is declining. I do not debate the equity of paying more for the old gas, but my concern is for my consumer clients we have got to have new gas drilled.

And I am fearful that rotling back the price on newly discovered gas will cause a very substantial decline in exploration.

Whether it is equitable or not, we found that old gas and what we are going to stay warm with is the gas we get the producers to drill in the future.

And my grave concern is anything that stops the wildcatters from exploring is going to have a very detrimental effect on the consumers in the not too distant future.

Senator **Melcher**. Well, Mr. Palmer, if the price is going to be lower, what is the stimulus for more activity for new wells?

Mr. **Palmer**. The stimulus of activity in wells is whether or not a company thinks they can make money out of drilling it.

What I was objecting to in this is the fact that we are absolutely going to put an arbitrary cap on the deep gas particularly, irregardless.

I think that if in fact the price goes down and a company can't drill to discover new gas, we are going to have to wait till a shortage occurs and the price of gas goes up to justify that.

Senator **Melcher**. Well, is your testimony in favor of the Reagan proposal on the basis of the Reagan proposal being modified to remove the cap?

Mr. **Palmer**. I think that my testimony is in total support of the Reagan proposal, but I would like to see the cap removed for gas below 15,000 feet.

If it can't be sold to the consumer for a greater price than the cap, we will accept that.

Senator **Melcher**. Well, is it your understanding that the cap would not apply then to the deep gas?

Mr. **Palmer**. It is my understanding that deep gas below 15,000 feet, if it goes into play, sure a producer can pay you more, but he cannot flow that cost increase through.

And essentially the price is going to end up regulated, and if it is in fact regulated, we are not going to be able to drill those deep, expensive wells.

Senator **Melcher**. I don't want to get any more confused than I am, but—I first of all got the impression—you testified first—that you were basing your advocacy of the Reagan bill—615, I believe it is—on the basis that there would be more capital available for more wells to be drilled because there would be freedom in the market.

Now is that correct?

Mr. **Palmer**. No, sir. All I am trying to say is I think we ought to deregulate gas and let the consumer decide how much gas is worth.

Senator **Melcher**. But deregulated under the terms of the Reagan proposal?

Mr. **Palmer**. Yeah, the problem that I see we have is—and the question before us is who is going to pay for all the mistakes.

That seems to be the continued thing that comes up: who is going to pay for the mistakes. Well, the biggest mistake that any company can make is to drill a dry hole.

If you have got regulatory authority setting prices, those prices are going to be based on some increment over cost.

If you have the free market setting prices, the guys that make the mistakes go out of business and so the consumer doesn't pay for that.

And I think it is just that simple.

Senator **Melcher**. All right. What your hope then is that, referring again to Mr. Thompson, is that his model, which shows the Reagon proposal producing a lower price by 1988 than under NGPA, you are just hoping that that model is wrong.

Mr. **Palmer**. Well, I have never accepted any projections of what any price is going to be at some time in the future, and it served our company reasonably well to not believe this.

Senator **Melcher**. Fair enough. Mr. Mut, I want to ask a question that has nothing to do with your testimony, but it has something to do with gas on the North Slope.

At what point do you project that reinfusing the gas and the oil production on the North Slope as far as Arco is concerned will become so costly that it will inhibit or will, just because of the mechanics of the well itself, cause lifting costs to be so much more that you will have less production in your wells?

Mr. **Mut**. I understand the question. As nearly as we can project at this time, that is not a problem to the end of the depletion of the oil reservoir.

Senator **Melcher**. Oh, it is not?

Mr. **Mut**. That is correct.

Senator **Melcher**. At what point did you decide that?

Mr. **Mut**. Right now, sir.

Senator **Melcher**. Right now? I think the testimony 2 years ago was that some time in 1987, 1988, or 1989 it might cause that, but you don't believe it will now?

Mr. **Mut**. No, sir. As the oil production diminishes, which will begin to occur toward the end of this decade, the gas production that comes along with it will also diminish, so the reinjection costs go down in proportion to the oil production.

So as a first approximation, it has no effect to the end of the life of the oil reserve then.

Senator **Melcher**. All right. And then one final question. What is the value that you set on the oil of Arco's production on the North Slope that Valdez ordered on the tankers?

Mr. **Mut**. Gosh, I would have to stop and count.

Senator **Melcher**. Maybe you can provide that for the record.

Mr. **Mut**. Yes, I can.

Senator **Melcher**. I have been told that it is somewhat less—right around $18, and I would just be curious if that is true.

Mr. **Mut**. Not at Valdez.

Senator **Melcher**. Not at Valdez?

Mr. **Mut**. It is close to that number——

Senator **Melcher**. At the wellhead?

Mr. **Mut**. Yes.

Senator **Melcher**. And at the wellhead it is a question of whether—that is where the value is established for the State of Alaska; is that correct, at the wellhead or at Valdez?

Mr. **Mut**. Yes, sir.

Senator **Melcher**. If you would supply that for us for the record, I would appreciate it.

Mr. **Mut**. I would be glad to.

Senator **Melcher**. Thank you very much.

Senator **Ford**. Mr. Chairman, I want to ask——

The **Chairman**. Senator Ford.

Senator **Ford** [continuing]. One quick question Mr. Mut, what percentage of your gas is on take or pay?

Mr. **Mut**. I don't have that number. Let me see if one of my associates does.

[Pause.]

Mr. **Mut**. The estimate was that our contracts, taken as a whole, probably 85 percent of them have some form of take or pay clause in the contract.

Senator **Metzenbaum**. Mr. Murray, what percentage is that, then, of your volume?

Mr. **Mut**. Well, approximately the same percent. Now the degree to which take or pay is specified is quite different from contract to contract.

Senator **Metzenbaum**. Would you supply the information to that question to the Committee in writing?

Mr. **Mut**. Yes, sir, surely.

Senator **Metzenbaum**. Mr. Murray, what incentive to seek new natural gas would be the deregulation of old gas?

Mr. **Murray**. I am not able to describe it. It is probably there, but as has already been stated, those who mostly have the old gas are not the independent producers who are doing the wildcatting.

Senator **Metzenbaum**. You have no judgment, then, whether deregulation of old gas would give incentive to go out and find new gas?

Mr. **Murray**. I fear that it would not have the incentive that the present price, which is in my judgment below the market clearing price for 102 gas, does have plus, sir, if you played, I presume, at Fort Hood a little poker and you kind of like——

Senator **Metzenbaum**. Is that North Hood or South Hood?

Mr. **Murray**. You kind of like to know what the rules are, and you waste a lot of time every time you change the rules.

And so part of it is we have gotten used to—I am not saying one above the other, but I just hate to have a long period of uncertainty and changing the rules after you have already made your bet.

And some independent producers—Frank Pitts, quite a wildcatter, chairman of the Texas Independent Producers Royalty Owners Association, said if you are going to take away my—I have discovered a lot of gas, just barely breaking even on it—of course, they all cry that way—but if you are going to roll it back after I have done it, I will quit.

If enough folks start saying that, then we are in bad shape over here. That is my concern.

Senator **Metzenbaum**. I wouldn't want you to be in bad shape. Thank you, Mr. Chairman.

The **Chairman**. Thank you all very much. I appreciate your testimony this afternoon.

Now we will hear from the last panel, panel No. 4, National Association of Manufacturers, represented by Mr. James S. Rubin, Allied Corp., Natural Oil Jobbers Council, represented by Chris Weber, president of Weber Oil Co., Mr. John Buckley, Northeast Coalition for Energy Equity, Mr. George Rosenthal, chairman of the National Affairs Committee, Independent Bakers Association, and Mr. Donald Fonville, Richmond United Neighborhoods.

Mr. **Rubin**. Thank you.

The **Chairman**. The rules under which we are operating today—a 5 minute limit on your oral presentation. Your entire written statement will be placed in the record and then we will proceed to the questions.

With that, Mr. Rubin, if you will proceed, please.

STATEMENT OF JAMES S. RUBIN, DIRECTOR, LEGISLATIVE AND REGULATORY AFFAIRS, ALLIED CORP., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURES, ACCOMPANIED BY H. RICHARD SEIBERT, NAM VICE PRESIDENT FOR RESOURCES AND TECHNOLOGY, AND ROBERT KIERNAN, NAM DIRECTOR OF ENERGY

Mr. **Rubin**. Thank you, Mr. Chairman. I am director of legislative and regulatory affairs for the Allied Corp. I am appearing on behalf of the National Association of Manufacturers in my capacity as chairman of the fossil fuels task force.

I am accompanied today by H. Richard Sekberg, NAM vice president for resources and technology, and by Robert Kiernan, NAM's director of energy.

We commend the committee for holding these hearings and thank the chairman and his staff for affording us the opportunity to express our views on the merits of this natural gas legislation proposed by the administration.

As you know, Mr. Chairman, this is not our first appearance before you on this matter, so I will be very brief.

NAM is a voluntary membership organization representing approximately 12,500 companies which employ a majority of the country's industrial labor force and which produce over 85 percent of the Nation's manufactured goods.

The association is also affiliated with an additional 158,000 businesses through the NIC and their associates 'department.

We are testifying before the Committee today on behalf of industrial users of natural gas. The industrial sector of the American economy accounts for more than 40 percent of all the natural gas consumed in this country.

NAM was, I believe, the first nonproducer organization to call for total deregulation of all natural gas wellhead prices by a date certain.

NAM's advocacy for the deregulation of all wellhead price controls is based on the following considerations:

Supply, national security, regional price disparities, conservation, and artificial demand constraints.

Despite the proliferation of rhetoric, ideas and legislation on natural gas, there appear to be only three real options—remaining with the NGPA, impose a piecemeal fix, or more toward a competitive free market for gas.

The last of these three options embodied in the administration's proposal is the only one which is a true remedy to our natural gas problems.

The responsible NAM committees initiated an in-depth analysis of the administration's proposal with the basic tenets of NAM's position in mind.

Yesterday, NAM's board of directors, consisting of this Nation's leading industrialists and representing virtually every sector of American industry, unanimously approved a resolution generally supporting the administration's proposal and commending it for its balanced natural gas proposal to protect consumer interests during a transition period while arriving at a competitive free market for all natural gas by a date certain.

Passage of legislation which strives to reform the many serious problems from wellhead to burner tip will be difficult and requires a spirit of cooperation from many interests.

NAM views the administration's proposal as the best vehicle for moving the legislative process forward. While not every element of S. 615 may be acceptable to the total membership, we feel that issues can be resolved in the context of the basic principle of arriving at a competitive free market for all natural gas.

That concludes my statement, Mr. Chairman.

[The prepared statement of Mr. Rubin follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS
BY
JAMES S. RUBIN
ALLIED CORPORATION

ON

NATURAL GAS LEGISLATION

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON ENERGY AND NATURAL RESOURCES

MARCH 12, 1983

My name is James S. Rubin, and I am Director of Legislative and Regulatory Affairs for the Allied Corporation. I am appearing on behalf of the National Association of Manufacturers (NAM) in my capacity as Chairman of the NAM Energy Committee's Fossil Fuels Task Force. I am accompanied today by H. Richard Seibert, NAM Vice President for Resources and Technology, and by Robert Kiernan, NAM's Director of Energy.

We commend the Committee for holding these hearings and thank the Chairman and his staff for affording NAM the opportunity to express its views on the merits of natural gas legislation introduced in the Senate during the first two months of the 98th Congress.

The NAM is a voluntary membership organization representing approximately 12,500 companies which employ a majority of the country's industrial labor force and which produce over 85 percent of the nation's manufactured goods. The Association is also affiliated with an additional 158,000 businesses through the National Industrial Council and NAM's Associations' Department.

The NAM is testifying before the Committee today on behalf of industrial users of natural gas. The industrial sector of the American economy accounts for more than 40 percent of all the natural gas consumed in this country. Therefore, industrial users have a vital interest in the present state of natural gas policy and regulations.

NAM was one of the first non-producer organizations to call for total deregulation of all natural gas prices by a date certain. NAM's advocacy for the deregulation of all wellhead price controls by a date certain is based on the following principles:

- An unregulated natural gas market would give a greater supply response than a regulated market such as under the Natural Gas Policy Act (NGPA).
- By restraining domestic natural gas exploration and production, NGPA has impeded the nation's ability to further reduce oil imports, thereby threatening the national security.
- NGPA's gas access and pricing provisions have resulted in inequitable regional price disparaties, thereby introducing unfair competitive advantages and disadvantages among industries.
- Artificial, regulated prices for natural gas have discouraged conservation.
- The Powerplant and Industrial Fuel Use Act of 1978 (FUA) and incremental pricing under Title II of NGPA are artificial, non-market demand constraints which have seriously distorted gas consumption patterns.

An unregulated natural gas market would give a greater supply response than a regulated market such as under the NGPA. Under the NGPA pricing scheme, neither "old" gas or "new" gas wellhead prices approach the incentive price needed to boost gas exploration and production activity to its highest possible level. The NAM is well aware that the latest reserve to production ratio for natural gas stands at 114 percent. However, the majority of this production consists of high-cost gas at the expense of lower-cost shut-in supplies. NAM believes an unregulated natural gas market will provide a greater and more economic supply response than would a regulated market. Without the free market economic incentives needed to explore for and produce additional natural gas supplies, the nation could very well face continued supply distortions and shortages in the years ahead.

By restraining domestic natural gas exploration and production, NGPA has impeded the nation's ability to further reduce oil imports, thereby threatening the national security. The NAM believes that continued reliance upon imported oil poses, by its very nature, a national security threat.

The nation remains vulnerable because development of other energy resources--resources that could further reduce our dependence on foreign energy--have been impeded, in part, by federal legislation such as NGPA. Every additional 1 trillon cubic feet of gas produced in this country represents 500,000 barrels of oil less per day that this nation would have to import. Maximizing efficient and economic domestic natural gas production will further assist in pressuring foreign oil producers to maintain price stability, because more American natural gas can mitigate long-term demand for foreign oil.

NGPA's gas access and pricing provisions have resulted in inequitable regional price disparaties, thereby introducing unfair competitive advantages and disadvantages among industries. The NGPA has produced a widely varying patchwork of natural gas prices in the United States. As a result of NGPA, pipelines serving different parts of the country will pay widely varying prices for natural gas, to the advantage of some users and the disadvantage of other users. Under NGPA the competitive viability of many of NAM's member companies is determined by what pipeline they are purchasing from rather than how well-managed or efficient they are. These inequities will be severely exacerbated in 1985 when the price of only "new" natural gas will be deregulated. NGPA's part-regulated, part-deregulated structure makes industrial users in intrastate markets vulnerable to a "fly-up" in prices if interstate pipelines bid the price of deregulated gas above market levels and away from intrastate markets in 1985.

Artificial, regulated prices for natural gas have discouraged conservation. The NGPA, in addition to restraining domestic natural gas exploration and production, encourages the wasteful utilization of gas and reduces the incentive to conserve this premium fuel.

The Powerplant and Industrial Fuel Use Act of 1978 (FUA) and incremental pricing under Title II of NGPA are artificial, non-market demand constraints which have seriously distorted gas consumption patterns. The FUA artifically restricts natural gas utilization by an outright ban on certain industrial uses. The incremental pricing provisions under Title II of NGPA require some industrial users to pay more for natural gas than other types of users pay. The FUA and incremental pricing are artificial non-market demand constraints which further distort gas consumption patterns and render overall gas use more inefficient.

Congress Has Three Options

Despite the proliferation of rhetoric, ideas and legislation on natural gas, Congress, in fact, has only three real options -- remaining with the Natural Gas Policy Act of 1978 (NGPA), imposing re-regulation on the natural gas market, or moving toward a competitive free market for gas. The last of these three options, embodied in the Administration's proposal, is the only option which is a true remedy to our natural gas problems.

The problems inherent in the NGPA are well known to this committee and to all those who have evaluated the NGPA's performance since it was enacted in 1978. The NGPA was a well intentioned compromise that was unfortunately based on invalid assumptions and miscalculations of market trends. NGPA is a confusing and inhibiting regulatory scheme which has resulted in uncertainties, inefficiencies, market distortions and pricing disorder. The current perplexing and imperfect results of the NGPA were not the intent of Congress in 1978.

Despite the rapidly changing trends in energy markets in general, and in the natural gas market in particular, the essential reasons for NAM advocating amendments to the NGPA and the total deregulation of all natural gas are still compelling. Clearly, advocating the 'do nothing' approach will mean that NGPA problems will not only continue, but will grow worse.

The second option which Congress must examine is that of a piecemeal approach to the problem. This approach is embodied in the numerous proposals put forth in the 97th and 98th Congresses which call for such actions as freezing wellhead prices, extending NGPA price controls beyond 1985, rolling back certain price increases, eliminating certain contract provisions, and other methods of intervening in the gas market. While on the surface these 'so-called' solutions may appear attractive, they are in fact counterproductive in the long run and will only exacerbate the existing difficulties. They are piecemeal actions which are aimed at the symptoms and not the true causes of the problem -- the NGPA and government intervention in the marketplace.

Reregulating gas prices would have a serious effect on the future supply of natural gas. Exploration and development of new gas supplies would become less attractive to producers, and they would have less revenue to finance these activities. The result would be severe economic strain on the producing industry and shortages of gas in the future.

Creating a shortage situation would harm the consumer and lead to higher prices. It would require a greater reliance on imported gas which is many times more expensive than domestic gas supplies. Lower volumes of available gas resulting from a wellhead price freeze may require pipelines and distributors to raise their prices to consumers to cover their fixed costs.

Shortages of natural gas would also harm our economy, threatening industrial activity and employment. During the winter of 1976-77, prior to the partial decontrol action of the NGPA, there were severe shortages of natural gas. During one week in Feburary of 1977, 1.2 million people were unemployed due to gas shortages. Several states were forced to declare a state of emergency and close plants, factories and schools.

A piecemeal contracts fix that is not a part of an overall comprehensive natural gas reform package is completely unacceptable to the NAM membership. The contracts problem is only one of many problems in the nation's natural gas market. Focusing on contracts alone does not adequately address any of NAM's principle objections to the NGPA. In fact, we fear that it would have negative supply repercussions.

The final option, The Natural Gas Consumer Regulatory Reform Amendments of 1983 (S. 615) introduced by Senator McClure (R-ID) on behalf of the Administration is a comprehensive, workable compromise which encompasses three basic elements: consumer protection; contract relief; and free competitive markets.

The responsible NAM committees initiated an in-depth comparison of the Administration's proposal with the basic tenets of the NAM position. On March 11, 1983, the NAM's Board of Directors, consisting of this nation's leading industrialists and representing virtually every sector of American industry, overwhelmingly approved the following resolution:

> "NAM commends the Administration for its balanced natural gas proposal to protect consumer interests during a transition period while arriving at a competitive free market for all natural gas by a date certain.
>
> We generally support the Administration's proposal and look forward to working with the Administration and the Congress to achieve a competitive natural gas market."

Conclusion

The comprehensive nature of the Administration's proposal, which strives to reform many serious and intractable problems from the wellhead to burnertip, will obviously require a spirit of cooperation from each sector of the industry. The NAM views the Administration proposal as the best vehicle for moving the legislative process forward. While not every element of S. 615 may be acceptable to the NAM membership, we feel that these issues can be resolved in the context of the basic principle of arriving at a competitive free market for all natural gas.

Above all, the essential message the NAM would like to impress upon this Committee, is that while the Administration's proposal may not be totally acceptable to any one segment of society or industry, the NAM believes it to be a balanced approach to the many complex problems in the nation's natural gas market.

Again, we thank the Chairman and the Committee for this valuable opportunity to discuss NAM's perspective on the resolution of problems in the nation's natural gas market.

The CHAIRMAN. Thank you, very much. Mr. Chris Weber of the National Oil Jobbers Council.

STATEMENT OF CHRISTIAN M. WEBER, JR., NATIONAL OIL JOBBERS COUNCIL

Mr. WEBER. Thank you, Mr. Chairman. I am here today representing the National Oil Jobbers Council, representing thousands of small business marketers who distribute heating fuel and motor gasoline throughout the United States.

We commend the chairman and the members of this committee for tackling the controversial issue of natural gas early in this session of Congress.

Today, I would like to discuss the impact of current natural gas laws, our experience with crude oil deregulation and markets, and several proposals introduced in Congress to address the natural gas problems.

Before I discuss current natural gas laws and NOJC's position, I would like to briefly outline an area of growing concern to petroleum product distributors.

A dangerous myth has developed that natural gas is a domestic fuel while petroleum is a foreign energy source. Nothing could be further from the truth.

The petroleum industry is a domestic industry employing hundreds of thousands of U.S. workers and millions more in directly related fields who rely on petroleum and its hydrocarbons for raw materials from which products are made.

Petroleum is the leading domestic fossil fuel, representing more than 43 percent of the energy consumed in the United States.

In contrast, natural gas is second, representing 27 percent of domestic energy used, and coal is third at 22 percent.

We don't feel it should be immoral or unpatriotic to use petroleum. It is immoral to waste it, and we have encouraged our customers to use their petroleum as efficiently as possible.

Natural gas prices are currently escalating much more rapidly than heating oil prices. These relative price trends make heating oil a more competitive fuel.

Because of these trends, there are those who believe that maintenance of the status quo; that is, the NGPA, is the alternative most appropriate for fuel oil marketers to support.

However, those who believe that maintenance of the status quo will best serve the interests of heating oil marketers are neither familiar with our problems nor with our market philosophy.

Heating oil marketers well remember being severely damaged in the past due to Federal natural gas policy, which held natural gas prices at unrealistically low levels.

Heating oil marketers do not want to be advantaged or disadvantaged by Government laws and policies that impact the home energy market.

Marketers support proposals that deregulate natural gas, which is the only domestic fossil fuel currently regulated by the Federal Government.

And we believe that every energy source should compete on its own merits in the marketplace. NOJC supports the administration's proposed legislation S. 615, although we would prefer to see a more straightforward deregulation bill developed by the administration.

Nevertheless, we will aggressively support S. 615 because it does represent legislation designed to deregulate natural gas markets.

We will continue to strongly support S. 615 as long as it contains all the essential features of the legislation as it was introduced; that is, full decontrol of all natural gas by a date certain.

In addition to S. 615, several other natural gas legislative proposals have been introduced. NOJC feels that these other proposals are narrow, piecemeal approaches to an extremely broad and complex set of problems.

We are particularly concerned about S. 689. We cannot support S. 689 because it represents a bill designed to re-regulate, not deregulate natural gas prices.

S. 689 builds upon the existing NGPA laws, the very laws which have caused the distortions in today's natural gas markets.

It continues existing controls on old gas which are the principal cause of many of the distortions we are trying to address today through legislation.

It is legislation designed to continue the discriminatory and predatory nature of existing Federal natural gas law vis-a-vis fuel oil and other alternate fuels.

By continuing regulation of old natural gas, it virtually guarantees a lower price for natural gas and just exacerbates the existing artificial competitive rate which natural gas receives as compared to other fuels.

Today, the natural gas consumer operates under a miscomprehension that there is some Government protection that can return natural gas to the unrealistically low price levels which they have seen in the recent past.

Rising energy prices is a reality that consumers of fuel oil, motor gasoline and other petroleum products have faced and responded to over the past several years.

Natural gas consumers will respond, as have oil consumers, when they recognize they must pay the true market value for the natural gas they consume.

Since 1978, consumers of oil products have achieved permanent savings through conservation and more efficient use of fuel oil on the order of 30 to 50 percent.

Oil equipment has made great strides in increased efficiency, and this advanced heating oil equipment has actually been installed in millions of homes.

We are proud of this record. NOJC urges the Senate to avoid a knee-jerk reaction to natural gas market problems, as some have advocated.

Consumers of petroleum products have experienced deregulation. Prices for petroleum products initially increased, but have been steadily declining today.

These market forces would have never been in effect if Congress had not deregulated crude oil. Consumer advocates who predicted $2 a gallon gasoline by Christmas of 1980 were wrong.

We urge that the Senate take a long-term view of natural gas deregulation, recognizing that in the long run deregulation of natural gas prices is the best policy.

We believe the administration's bill takes a long view and we urge that the Senate act as swiftly as possible in support of this.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Weber follows:]

Testimony of
Christian M. Weber, Jr.
on behalf of the
National Oil Jobbers Council

PREFACE

The National Oil Jobbers Council is a federation of 42 state and regional trade associations representing thousands of independent small business petroleum marketers. Members include gasoline and diesel fuel wholesalers, commissioned distributors of gasoline, gasoline reseller-retailers and a large number of retail fuel oil dealers. Members also wholesale or retail many other petroleum products, including kerosene, LP gas, aviation fuels and motor oils as well as residual fuel oil. Together our members market approximately 50 percent of the gasoline and 85 percent of the home heating oils sold in America under either their own private brand or the trademark of their supplier.

Good morning. My name is Christian Weber, Jr. and I am President of Weber Oil Company, a heating oil and gasoline distributorship in Camden, New Jersey. I am appearing today in my capacity as a member of the Heating Fuels Committee of the National Oil Jobbers Council (NOJC). The NOJC represents thousands of small business marketers who distribute primarily heating fuels and motor gasoline. Collectively, these marketers distribute 85 percent of the home heating oil and 50 percent of the gasoline sold in the United States to the consuming public.

NOJC commends the Chairman and members of the Senate Energy and Natural Resources Committee for tackling the controversial issue of natural gas early in this session. Thousands of fuel oil marketers serving more than 16 million American homes are looking for Congress to provide the long-needed relief from unfair natural gas competition fostered by federal policy which has previously artificially subsidized natural gas prices in the home heating marketplace, and which is currently operating to push natural gas prices upward in spite of the fact that natural gas consumption is down and there is a surplus market. Today, I would like to discuss the impact of current natural gas laws, our experience with crude oil deregulation and markets, and several proposals introduced in Congress to address the natural gas problems.

PETROLEUM: A DOMESTIC INDUSTRY

Before I discuss current natural gas laws and NOJC's position on the Administration bill (S 615) and other legislative proposals (particularly S 689), I would like to briefly outline an area of growing concern to petroleum product distributors.

A dangerous myth has developed that natural gas is a domestic fuel while petroleum is a foreign energy source. Nothing could be further from the truth. The petroleum industry is a domestic industry employing hundreds of thousands of U.S. workers and millions more in directly related fields who rely on petroleum and its hydrocarbons for raw materials from which products are made. Petroleum is the leading domestic fossil fuel representing more than 43 percent of the energy consumed in the United States. In contrast, natural gas is second representing 27 percent of domestic energy used, with coal third at 22 percent. Federal policy, like the regulation of natural gas or an oil import fee, which discriminates against one domestic fossil fuel over another is short-sighted and dangerous to the American economy.

CURRENT NATURAL GAS POLICY

Natural gas prices are currently escalating much more rapidly than heating oil prices. These relative price trends make heating oil a much more competitive fuel (although in most areas of the country natural gas still enjoys a price advantage). Because of these trends, there are those who believe that maintenance of the status quo is the alternative most appropriate for fuel oil marketers to support. However, those who believe that maintenance of the status quo will best serve the interests of heating oil marketers are neither familiar with our problems nor with our market philosophy. Heating oil marketers remember being severely damaged in the past due to federal natural gas policy, which held natural gas prices at unrealistically low levels and resulted in:

- an inequitable price subsidy to natural gas consumers, which was not shared by consumers of other domestic fossil fuels;
- two-three million uneconomic conversions from fuel oil to natural gas on the basis of this artificial price bias; and
- fuel oil distributorships being subsequently forced out of business, with a loss of service to the customers who enjoyed and depended upon the fuel oil distribution system to service their needs.

Heating oil marketers do not want to be advantaged or disadvantaged by government laws and policies that impact the home energy market. Marketers support proposals that deregulate natural gas, the only domestic fossil fuel currently regulated by the federal government, and believe every energy source should compete on its own merits in the marketplace. NOJC believes that Congress should address this problem in a comprehensive, not a piecemeal, manner and accelerate the partial deregulation scheduled under the NGPA to completely deregulate the wellhead price of all natural gas by January 1, 1985.

THE ADMINISTRATION BILL - S 615

NOJC supports the complete and total deregulation of natural gas at the earliest possible date. We would have preferred to have seen a much more straight-forward deregulation bill developed by the Administration. Nonetheless, we will aggressively support S 615, as introduced by Chairman McClure, because it does represent legislation designed to deregulate natural gas markets. We will strongly support S 615 as long as it continues to contain all the essential features of the legislation as it was introduced. The alternatives to the Administration's legislation beg for continuation of the status quo, or worse, more regulation and the creation of even greater distortions in the natural gas market.

Briefly, I would like to outline those provisions of S 615 that NOJC particularly supports and explain our concerns about possible problems that may evolve from other sections of the proposed legislation.

Deregulation of Old Gas

NOJC supports in particular the provisions of the legislation which include the deregulation of all so-called "old" natural gas which is forever regulated at below market levels under current NGPA law. We urge the members of this Committee who support this broad compromise package not to waiver on these provisions, which are the backbone of the legislation and which allow a true market to begin to operate on January 1, 1986. These provisions are essential to the achievment of true deregulation.

Repeal of Fuel Use Act Restriction on Petroleum

NOJC also supports the provisions which repeal the Powerplant and Industrial Fuel Use Act prohibitions and restrictions on the use of petroleum products as a primary energy source in existing powerplants that used coal or another alternate fuel in 1977. Utilities and industrial manufacturers should be allowed to choose any fuel that is available to generate power.

Areas of Concern

NOJC recognizes the delicate balance of constituencies which the Administration has attempted to address with this legislation. Nevertheless, from any policy perspective, be it energy, economic, foreign or domestic, the deregulation of natural gas should not be delayed. Of primary concern to independent small business marketers of heating fuels is the extension of federal price controls on natural gas beyond January 1, 1985 through the proposed January 1, 1986 operation of the purchased gas adjustment "pga" limitation. We believe the extension, until 1986, of the "pga" limitation is unnecessary and should be amended. The legislation should establish a termination date not later than January 1, 1985 for the operation of the "pga" limitation.

We recommend that the legislation be amended in the following manner:

> Option 1: Establish a "market-out" date of January 1, 1984 for any contract that has not been re-negotiated with the "pga" limitation remaining in effect until January 1, 1985;
>
> Option 2: Establish a "market-out" date at a set time after enactment (i.e. 60, 90 days) of the legislation with the "pga" limitation remaining in effect until January 1, 1985.

The change would not alter the general nature or thrust of the Administration's proposal, which is to incorporate a strong element of consumer protection.

Legislation Should Not Discriminate Against Competing Fuels

NOJC does not believe it is necessary to establish an additional "cap" on well-head natural gas prices during the deregulation process, particularly if the legislation includes the "pga" cost passthrough restrictions on pipelines. If a capping mechanism is retained, it should not be discriminatory to users of other fuels. For example, a cap should not target natural gas prices to a percentage equivalent of a crude oil or residual fuel oil price. Further, the section 603 "Limitation on the Passthrough of Certain Gas Costs" provisions should permit broad flexibility in the passthrough.

Finally, the Section 301 provisions which provide a transitional capping mechanism should not include re-negotiated contract prices in the market cap. This cap is meant to be a market price cap and should reflect the average price of new contracts. Including re-negotiated contracts in the market cap could undermine the intent by diluting the market cap with re-negotiated contract prices that are below market prices. The transitional price cap provides ample protection without the inclusion of re-negotiated contracts. That cap will be the lesser of the NGPA natural gas price or the market cap.

OTHER NATURAL GAS LEGISLATIVE PROPOSALS

In addition to S 615, several other natural gas legislative proposals have been introduced. NOJC feels that these other proposals are narrow, piecemeal approaches to an extremely broad and complex set of problems. We are particularly concerned about S 689. NOJC cannot support S 689 because it represents a bill designed to re-regulate, not deregulate natural gas prices. S 689 builds upon the existing NGPA laws, the very laws which have caused the distortions in today's natural gas markets. It continues existing controls on "old" gas which are the principal cause of many of the market disortions which we are trying to address through comprehensive legislation. It is legislation designed to continue the discriminatory and predatory nature of existing federal natural gas law vis-a-vis fuel oil and other alternate fuels. By continuing regulation of "old" natural gas, it virtually guarantees a lower price for natural gas and exacerbates the existing artificial competitive edge which natural gas receives as compared to other fuels. This legislation represents a step backward from existing law by maintaining the status quo and adding a whole host of complicated mechanisms which are designed to favor natural gas as an energy source. As has been mentioned, NOJC supports legislation that is comprehensive and which deregulates natural gas so that all energy sources, including natural gas, must compete on their relative merits in the marketplace.

FUELS SHOULD COMPETE ON THEIR MERITS

Home heating oil marketers urge the Senate to deregulate natural gas and allow all fuels to compete on their merits in the marketplace. Today's natural gas consumer operates under a misconception that there is some government protection that can return natural gas to the unrealistically low price levels which they have seen in the recent past. Natural gas consumers need to realize the value of energy in today's world and expect to pay a true market value for that fuel. Rising energy prices is a reality that consumers of fuel oil and other petroleum products have faced and responded to positively over the past several years. Natural gas consumers will respond, as have oil consumers when they recognize they must pay the true market value for the natural gas they consume. Since 1978, consumers of oil products have achieved permanent savings through conservation and more efficient use of fuel oil on the order of 30-50 percent. Oil equipment has made great strides in increased efficiency, and this advanced heating oil equipment has actually been installed in millions of homes across the country resulting in savings to consumers of millions of dollars. We are proud of this marketer record of unparalleled achievement.

DEREGULATION OF PETROLEUM AND PETROLEUM PRODUCTS

The market system works. Fuel oil marketers are currently operating in a free market environment, and the market is showing us again, after a decade of federal control of our member's businesses, just how brutal the marketplace can be. Competition is ruthless and the petroleum product consumer is receiving the benefits of declining prices for products and an excess supply. Our experience since the deregulation of crude oil in 1981 has demonstrated beyond doubt that the consumer is best served when market prices are allowed to work. We urge the Senate to carefully examine the efficiencies and benefits which have accrued to the consumer in the short time since crude oil deregulation.

The evidence is compelling when comparing regulated natural gas and deregulated heating oil. In the months following crude oil deregulation the price of home heating oil has declined dramatically. During this period of time, natural gas prices have soared. This contrast is sharpened by the fact that during this period there was a surplus availability of both fuels.

The comparison is startling when looking at imports. The deregulation of crude oil has directly impacted the international market, and facilitated the consumer's power to influence world petroleum supply and demand. As compared to the first ten months of 1981, net imports of petroleum for the first ten months of 1982 declined 23 percent. The March 7, 1983 edition of the Journal of Commerce carried a story which reports that "U.S. crude oil imports dropped below 2 million barrels in the week ending February 25 and hit an 11-year low of 1.8 million barrels a day." In contrast, in the first ten months of 1982, imports of high priced foreign natural gas increased by 7.4 percent over the first ten months of 1981. These natural gas imports increased in the face of a 6.6 percent decline in natural gas consumption.

Deregulation of crude oil stimulated both a phenomenal reduction in U.S. dependence on foreign sources of petroleum and resulted in a continuation of domestic crude oil production levels. The regulated natural gas market during this time experienced a 7.7 percent decline in production due, at least in part, to lack of price incentives. Such a result is unavoidable when U.S. government policies permit pipelines to purchase expensive foreign natural gas costing between 5-10 dollars per mcf while freezing the price of huge amounts of domestic natural gas at levels as low as 28 cents-per-mcf. The Canadian, Mexican, and Algerian producers are laughing all the way to the bank with American consumer dollars.

QUALITY LOW INCOME ASSISTANCE NECESSARY

All consumers need to recognize that they must pay a market value for the energy they use. Those consumers who cannot afford to pay the true cost should receive assistance. NOJC has had a long-standing policy of supporting an adequate and effective low income energy assistance program. NOJC will continue to work with Congress as we have done in the past to ensure that an adequate amount of assistance is available for the needy, regardless of the fuel consumed. The cost of energy for all fuels is of concern, but if we have learned nothing else from our experience with oil decontrol, it is that prices can come down, energy assistance programs can be made to work, and Congress can help by ensuring that those programs are properly funded.

CONCLUSION

NOJC urges the Senate to avoid a knee-jerk reaction to natural gas market problems, as some have advocated. Consumers of petroleum products have experienced deregulation. Prices for petroleum products initially increased, but have been steadily declining due to market forces. These market forces would have been ineffective if Congress had prevented deregulation of crude oil as a reaction to rising fuel oil and gasoline prices. Consumer advocates predicted that deregulation of crude oil in 1981 would spell doom for consumers and would result in $2.00 per gallon gasoline by Christmas. Quite the contrary was true.

We urge the Senate to take a long term view of natural gas deregulation recognizing that, in the long run, deregulation of natural gas prices is good policy, in the nation's and consumer's best interests. We believe the Administration's bill takes this long view. We urge the Senate to act swiftly in support of the Administration's bill as introduced.

Thank you for the opportunity to testify on this important issue and I will be happy to answer any questions you may have.

MEMBERS OF THE NATIONAL OIL JOBBERS COUNCIL

NOJC represents these member associations:

Alabama Petroleum Marketers Association
Arizona Oil Marketers Association
Arkansas Oil Marketers Association, Inc.
California Independent Oil Marketers Association
Colorado Petroleum Marketers Association
Independent Connecticut Petroleum Association
Florida Petroleum Marketers Association
Georgia Oilmen's Association
Idaho Oil Marketers Association
Illinois Petroleum Marketers Association
Indiana Oil Marketers Association, Inc.
Intermountain Oil Marketers Association
Petroleum Marketers Of Iowa
Kansas Oil Marketers Association
Kentucky Petroleum Marketers Association
Louisiana Oil Marketers Association
Maine Oil Dealers Association
Michigan Petroleum Association
Mid-Atlantic Petroleum Distributors Association, Inc.
Mississippi Petroleum Marketers Association
Missouri Oil Jobbers Association
Montana Chapter, Intermountain Oil Marketers Association
Nebraska Petroleum Marketers Inc.
Independent Oilmen's Association of New England
Fuel Merchants Association of New Jersey
New Mexico Petroleum Marketers
Empire State Petroleum Association
North Carolina Oil Jobbers Association
Northwest Petroleum Association
Ohio Petroleum Marketers Association
Oklahoma Oil Marketers Association
Oregon Oil Jobbers Association
Pennsylvania Petroleum Association, Inc.
South Carolina Oil Jobbers Association
South Dakota Independent Oilmen's Association
Tennessee Oil Marketers Association
Texas Oil Marketers Association
Virginia Petroleum Jobbers Association
Washington Oil Marketers Association
West Virginia Oil Jobbers-Distributors Association
Oil Jobbers of Wisconsin, Inc.
Wyoming Petroleum Marketers Association

National Oil Jobbers Council
1707 H Street, N.W.
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(202) 331-1198

The Chairman. Mr. Buckley, your entire statement will be made a part of the record. The attachments thereto will be placed in the file.

STATEMENT OF JOHN G. BUCKLEY, COCHAIRMAN, NORTHEAST COALITION FOR ENERGY EQUITY, AND PRESIDENT, NORTHEAST PETROLEUM CORP.

Mr. Buckley. Thank you very much, Mr. Chairman. I would urge that staff and as many members as possible, particularly from the northeast part of the country, read that study and the documents, and particularly the study done by the Kennedy School at Harvard which spent a year and did 25 industry cases analyzing what the impact would be on our region of the country from natural gas decontrol.

And they are about to finish a study on the three Northwest States—Oregon, Washington, and Idaho—which will show State by State what the impact on these stats will be from natural gas decontrol.

And in each case it is so clear and so evident that the Northeast and the Northwest will benefit enormously in economic terms from decontrol to the tune of, you know, a billion and a half, $2 billion a year between those States from decontrol.

I would like today, if I might, rather than talk about my company's self-interest or my own—I know that is what usually happens here—or to discuss the specifics of the administration's proposal because you have heard a lot of that in 4 days, but rather speak to some of the fundamental, underlying issues and what is best for my region and what is best, in my view, for the country.

I think it is pretty clear that what we come down to here is a philosophical discussion between those who always favor Government controls and those who favor a free market approach.

It is clear to me that those who favor controls have just not been watching recent history and recent evidence because we have had a lot of different decontrol measures taken with trucks, with airlines, with oil, and the evidence is in, the facts are clear, and yet those who favor controls, it almost seems as if they never even had a course in economics.

They ignore the facts, they create specious arguments, and it is amazing that anyone pays any attention to what they think is going to happen because every time their predictions are totally wrong.

I think they have been thoroughly discredited. What really has decontrol brought in oil, in airlines, in trucking? It has brought intense competition, the correct price signals, more supply, less demand, lower profits for the companies competing—sharply lower—and lower prices.

There has only been one winner, and that winner has been the consumer. For a whole decade we ran oil energy policy to protect the poor.

It had nothing to do with energy; it had to do with protecting the poor from sharply rising prices, controls designed to force the price down.

Unfortunately, controls are not, you cannot suspend economic laws, and so the prices went up and the poor were hurt.

Now, of course, low-income people pose a social problem, and we have always favored and worked hard to help them through a low-income assistance program as a separate nonenergy program.

That needs to be done with gas as well. But you need to let the market work. You just can't hold the Nation's energy security hostage to a problem which is really a fairly small social problem.

When I say fairly small, not for the individuals involved, but in the context of the tens of billions of dollars we are talking about, it is a $2 or $3 billion solution.

I think you ought to decontrol natural gas tomorrow, not January 1, 1985, not January 1, 1986. To me, with oil prices going down worldwide—and I see that continuing this year, next year, at least through the 1980's and the real price of petroleum going down through the rest of the century—gas decontrol has got to compete with oil.

No one ever accused oil companies of not acting in their own best interest, and the oil companies produce and own most of the old gas.

And if gas is decontrolled, they will produce it and they will sell it at less than the cost of oil rather than bring in someone else's foreign oil that they make no profit on at all.

So basically I would say that the only commonsense answer and the ideal solution—and I know you can't fashion ideal solutions—but the ideal solution is total decontrol next week, next month, as quickly as possible.

That is what will help the consumer, that is what will restore interfuel competition. If you can't do that, fix up the NGPA so that all oil is decontrolled and not just new oil and let it run its course and get out of this control system on January 1, 1985.

I think the administration's approach is far too timid. What do we know about what will happen when you put a whole new set of regulations on with price caps?

I can tell you what will happen—it will result in new inefficiencies, distortions, and higher prices. Now we have had the NGPA for a few years, and in my part of the country, it has helped me.

I basically run a company that sells a lot of heating oil, supplies about a half a million customers, and the distortions and inequities in that NGPA now have gas priced above the cost of oil and we are going down and they are going up, we are in great shape, but I have to tell you what is good for me is certainly not good for my region, and I don't think good for the country.

I don't think it is good for the region that the studies that we have completed on 10 States is for—really, it is a disaster of waste for the Nation.

Thank you very much.

The **Chairman**. Thank you, Mr. Buckley.

[The prepared statement of Mr. Buckley follows:]

STATEMENT
# of the
NORTHEAST COALITION FOR ENERGY EQUITY
on
NATURAL GAS DECONTROL LEGISLATION

I. Introduction

My name is John G. Buckley. I am Co-Chairman of the Northeast Coalition for Energy Equity, and President of Northeast Petroleum Corporation, an independent marketer of petroleum products based in Boston.

The Northeast Coalition for Energy Equity is an ad hoc group formed to support efforts to end the discriminatory federal treatment between natural gas and home heating oil consumers. The Coalition represents approximately 4,000 home heating oil marketers serving over 8 million consumers in the nine states of the Northeast.1/ The members of the Coalition have a vital interest in natural gas decontrol and related pricing issues because they sell home heating oil at free market prices in direct competition with utilities that sell natural gas at lower, federally subsidized prices.

Natural gas decontrol is an essential step on the road toward national energy equity, efficiency and self-sufficiency. However, most critically for us, natural gas decontrol is necessary to preserve the independent home heating oil sector and eliminate the discrimination against home heating oil consumers in current federal policy. In the Northeast, the Pacific Northwest, and many other areas, home heating oil is the primary competition that subjects natural gas utilities to market forces.

1/ Attachment A is a list of the principal associations that are members of the Coalition.

II. Summary of Position

Natural gas decontrol should be accomplished promptly, if not immediately. There will be no benefit from delay. Gas deregulation should have been enacted two years ago. If it had, gas consumers would not now be experiencing the anomaly of rising gas prices in a surplus market. But the timidity of this Administration, and the reluctance of the prior Congress, to open the gas market to the benefits of market forces and interfuel competition has led to the current chorus of demands that the current regulatory system be changed.

The Northeast Coalition agrees that the system should be changed. But if Congress acts, it must move toward more prompt and complete deregulation of all gas prices. Congress must not supplant the Natural Gas Policy Act (NGPA) with a new and untested regulatory scheme that delays or distorts the clear benefits of market forces and free competition.

The Administration proposal, S. 615, is one step toward the goal of deregulation, and one step backward. The Administration proposal, by deregulating all categories of gas, would impose market forces on all gas transactions. However, by its imposition of new and complex regulatory provisions, including the proposed gas price "cap" and the proposed limitations on purchased gas adjustment passthroughs, the proposal would delay the benefits of competition until 1986. NGPA, on the other hand, with all its defects, would bring market forces to bear on the natural gas industry by January 1, 1985.

Congress should not replace NGPA with another regulatory scheme. If NGPA is amended at all, it must be by legislation that deregulates old gas, and ends all federal regulation of wellhead prices by January 1, 1985, at the latest. If Congress is unable to agree on legislation that leads to full market pricing for natural gas by 1985, NGPA should be allowed to run its course.

III. Natural Gas Price Regulation is Discriminatory and Wasteful

The members of the Northeast Coalition are not defenders of NGPA. That statute has irreparably injured the oil heat industry; it has discriminated against the nation's 12 million home heating oil consumers; and its has significantly disadvantaged the Northeast's competitive position.

However, despite the outcries from the gas distribution industry and their orchestrated chorus of consumer complaints, NGPA has had its intended effect. For its entire duration, it has kept natural gas prices below market levels. In fact, it has subsidized gas prices at levels that in many areas were less than half of the oil price equivalent. It continues to hold gas prices below oil prices in much of the country. As a result, NGPA has encouraged gas consumption, retarded conservation and restrained the installation of high-efficiency gas equipment.2/

2/ If the natural gas distribution industry had encouraged installation of high-efficiency equipment during the past

[Footnote cont'd next page]

Oil consumers have dealt with rising costs since 1973; in contrast, gas consumers have been insulated from market forces throughout this period. The gas industry has had five years, since enactment of NGPA, to prepare for the partial decontrol scheduled for January 1, 1985. The time has come for the gas industry to face the competition of the marketplace; for gas consumers to adjust, as have their neighbors who use fuel oil or electricity; and for industries near the producing areas to surrender their competitive advantage over industrial plants in the Northeast and Northwest.

Federal gas price regulation seriously discriminates against northeastern (and northwestern) consumers of both oil and gas. Despite claims to the contrary, NGPA has held the wellhead price and the burner tip price for most gas below the price of alternative fuels.[3] But cheap gas is not available

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[Footnote cont'd]

5 years, rather than promoted more than one million conversions from oil, decreased gas consumption would have offset consumers' higher unit costs. This decrease in consumption is how oil consumers have responded to decontrol; it is surely how gas consumers will respond. Home heating oil consumers have decreased their consumption since 1977 by more than 25 percent. In the same period, residential gas consumers have reduced aggregate consumption by less than 1 percent. The lesson is clear. Rising unit prices of gas do not result in commensurate increases in gas bills, if utilities encourage conservation.

[3] For example, the wellhead price in March 1983 for section 102 gas is $3.34; for 103 gas is $2.74; for section 106 gas is $1.56; for section 106 gas is $1.56; for section 108 gas is $3.58; and for section 109 gas is $2.27. Each

[Footnote cont'd next page]

in the Northeast (or Northwest) in any significant amounts. The Northeast (and Northwest) primarily use oil and more expensive gas supplies, to heat their homes and power their industries. Because of the dependence of the Northeast upon petroleum products, the NGPA increases the comparative cost of living and doing business in the Northeast, and therefore costs the region jobs.

In a recent Report by the Energy and Environmental Policy Center of the John F. Kennedy School of Government at Harvard University, the authors found that the Northeast region's "high dependency on oil has placed it at a substantial competitive disadvantage vis-a-vis those regions with access to plentiful price-regulated natural gas."4/ The differential between the average price of energy in New England and the rest of the nation was found to be 49 percent; in New Jersey, the differential was 43 percent. As a result, the Harvard Report found:

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of these is well below a crude oil equivalent price of $30.00/barrel. The Bureau of Labor Statistics data on the December, 1982 residential prices of natural gas compared to the residential heating oil price for 27 major markets in the U.S. is summarized in Attachment B.

4/ Natural Gas Decontrol: A Northeast Industrial Perspective" (October 1982) at 5. The Executive Summary of the Report is Attachment C. The complete report is being submitted to the Committee for inclusion in the hearing record.

> Industry in the Northeast uses little natural gas, is significantly less energy-intensive for each industrial category, and confronts significantly higher energy prices already. Since most Northeast industrial gas users will experience relatively lower cost increases due to higher natural gas prices, they would likely gain competitively from a policy of decontrol. Both profits and production in the Northeast would likely increase as energy costs in other regions came to reflect elimination of the artificial cost advantage historically created by controlled natural gas prices.5/

The Report also found that total income to the region would increase from $720 million to $1.53 billion annually if natural gas is decontrolled. Consequently, the Report concluded:

> The overriding single conclusion of this study is that both in terms of income flows and industrial competitiveness the Northeast will benefit from policies which allow natural gas prices to move toward parity with competitive fuels. Our analysis yields this conclusion despite the fact that we chose not to consider several unambiguously positive aspects of decontrol including improved efficiency of the national economy, reduced vulnerability to an oil supply disruption, and possible reductions in both the level and price of oil imports.6/

The discrimination resulting from gas price controls is not limited to the Northeast; it impacts oil consumers nationwide, increasing the price of all petroleum products, including gasoline, heating oil, aviation fuel, industrial fuel, SNG, and petrochemical feedstocks. This finding was made

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5/ Id. at 5.

6/ Id. at 6.

in a study performed for the Northeast Coalition by Madison Consulting Group (MCG) of Madison, Wisconsin under the direction of Dr. Charles J. Cicchetti.

The MCG study, "The Economic Effects of Deregulating Natural Gas"7/ evaluated the effects of gas price controls on oil and gas consumers nationwide, noting that about half of all residential energy users heat their homes with a fuel other than natural gas. The MCG study concludes that the price to consumers of oil products would decrease as a result of natural gas decontrol, and that these lower oil consumers' bills would offset any increases in gas consumers' bills. This conclusion is central to our interests in this issue; it cannot be ignored by Senators who are concerned about fairness to consumers.

Even northeastern consumers who use natural gas derive little benefit from NGPA price regulation and will not be harmed by decontrol. As the Committee is aware, NGPA channels gas price increases to purchasers with less than average access to "old" interstate gas. The pipelines serving the Northeast have little access to this cheaper gas; moreover, they must pay substantial transportation costs, and rely for a large portion of their heating season supplies on imported LNG, synthetic natural gas and , if approved, expensive Canadian imports.8/

7/ A copy of the complete MCG study is being submitted to the Committee for inclusion in the hearing record.

8/ Indeed, federal price regulation, by decreasing incentives for production and artifically increasing the price for

[Footnote cont'd next page]

Consequently, the major cities of the Northeast -- Boston, Providence, Hartford, New York, Newark, Philadelphia, Washington -- are the only metropolitan areas in the country (other than Honolulu) where gas prices have risen to oil price equivalent levels.[9]

This discrimination against Northeast oil and gas consumers is not the result of specific NGPA provisions that can now be repaired; it is the inevitable result of federal gas price regulation that attempts to provide other regions with much cheaper gas supplies. These disparities will continue with any regulatory scheme that seeks to hold the nation's supply to price levels that are below market value.

But with all its defects, NGPA has one overriding virtue: it has almost run its course. By January 1, 1985, if not sooner, consumer gas prices will be set by the forces of competition, not regulation. By January 1, 1985, all newly discovered gas will be able to command prices that reflect market value to the purchaser, rather then the ceiling price under federal regulation. Incentives will be in place for adequate

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[Footnote cont'd]

deregulated supplies, forces pipelines serving the Northeast and Pacific Northwest to pay more for new pipeline supplies and to rely on expensive supplemental sources and gas imports.

[9] See Attachment B for current data of the Bureau of Labor Statistics.

domestic supply and competitive pricing for consumers. Although old gas wellhead prices will remain under controls, this low cost cushion will not hold burner-tip gas prices below competing fuel levels. Unless all gas prices are controlled at levels below market value,10/ pipelines' competition for available higher priced gas will bring average prices up to the level of alternative fuels. This result has been the clear lesson of NGPA. It will occur inevitably under any regulatory scheme that applies below market price regulation to a portion of natural gas production, but permits market incentive prices for the remaining portion.

IV. Prompt Deregulation is the Most Effective Regulator

Decontrol of crude oil, heating oil, gasoline and deep gas prices have proved that market forces provide a far better incentive to increase supply and are a far better regulator of price than any form of federal regulation. Decontrol of all natural gas prices would have similar beneficial results, particularly if it is accomplished promptly, while world oil prices are declining.

All of our experiences with energy price decontrol have worked. First, residual fuel and distillate fuel oil prices

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10/ Continued control of all gas prices would lead inevitably to gas shortages, as it did in the 1970's. NGPA, by permitting incentive prices for new and high cost gas, has proved that market prices generate surpluses, not shortages.

were decontrolled in June and July 1976. Many claimed that prices would skyrocket, and an intensive federal price monitoring scheme was devised. During the course of this monitoring, not once were average heating oil prices higher than what they were expected to be under continued controls. Indeed, in the two years following decontrol, heating oil prices rose from only 40.6 cents per gallon to 49.4 cents per gallon, approximately the rate of inflation during the period.

Second, crude oil and gasoline prices reached their highest levels in history under federal price regulation, and have decreased steadily since they were decontrolled in January, 1981. The average U.S. refiner acquisition cost of crude oil has decreased from its all time high of $36.54/barrel in the first quarter of 1981 to an estimated $30.50/barrel today.11/ Similarly, gasoline prices, which decontrol opponents said would reach $2.00/gallon by 1982, reached its peak of 138.8 cents/gallon in March, 1981 and has declined under market pressures to 124.4 cents/gallon by December, 1982.12/

Third, the limited experience to date with decontrolled natural gas prices demonstrates that market forces work in the natural gas sector. Decontrolled deep gas prices, although reaching exceedingly high levels for a short period, have

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11/ Petroleum Industry Research Associates, Inc. data.

12/ Weekly Petroleum Status Report, EIA (February 18, 1983) at 17.

sharply receded to more reasonable market sensitive levels while regulated gas prices continue to climb. The temporary above-market price levels for decontrolled natural gas were indisputedly the result of the abundance of cheap below-market priced supplies in the purchasers' systems. But, even with the distortions caused by this old gas "cushion," market forces have reasserted themselves and substantially reduced the price for decontrolled gas.

This evidence cannot be ignored. It demonstrates that the supply and demand response to price changes, and the effects of interfuel competition, work to produce adequate supplies at competitive prices. These laws of economics work far better than any scheme developed by Congress and implemented by FERC, as has been proven by the operation of the Natural Gas Act and NGPA.

Congress should move to decontrol natural gas prices now, rather than wait until 1985 or 1986. The current conditions in the world oil market and the domestic surplus of natural gas make 1983 an ideal time to end all federal wellhead price regulation.

Dr. Paul London, in an analysis entitled "Limits on Natural Gas Price Increases Imposed by Market Demand," evaluated the effect of decontrolling old gas prices. The report concluded that increases in old gas prices would largely be absorbed by producers now commanding higher prices, and by exporters of gas to the U.S., principally, Canada and Algeria. Dr. London states that:

> Increases in section 104 prices, therefore would tend to bring the prices of various categories of production in the natural gas market together, reducing the market disorder, i.e., the uneven competitive position of pipelines and consuming regions that now prevails. Consumers as a whole will benefit if the bargaining position of various pipelines is brought into better balance.

The analysis by Dr. London, submitted to FERC in August 1982, is equally applicable today, because of the further decline in crude oil prices.13/

The results predicted by Dr. London would be guaranteed if total decontrol is accompanied by incentives to encourage renegotiation of existing high-priced contracts. Producers would be able to command higher prices for old gas only if existing contracts with above-market price terms were renegotiated downward. Pipelines would agree to renegotiated terms for old gas only if their resulting average gas prices were competitive with alternative fuels. Fear of a "fly-up" from increases in old gas prices are completely unfounded. Such a fly-up cannot occur if competitive fuel prices are low, as they are now.

However, Congressional action abrogating or modifying existing gas contracts should only be taken if it is accompanied by decontrol of all gas prices. Contract

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13/ A copy of the Analysis has been submitted for inclusion in the Committee hearing record.

abrogation is a radical legislative remedy; it is a precedent that should be avoided. Forced renegotiation of private contracts would be appropriate only if Congress were to change the regulatory structure under which these contracts were negotiated. If the rules are different, the contracts should reflect the parties' needs under the new rules. If the regulatory structure is not removed, but only revised, contract abrogation would surely create new and unanticipated regulatory problems. New contracts would reflect the expected market distortions of the new regulatory scheme. If contracts are to reflect the long term market needs of the parties, rather than their regulatory expectations, all wellhead price regulation must be removed concurrently with renegotiation.

In addition, no wellhead price "cap" or rigid pipeline passthrough limitations should be included in decontrol legislation if the benefits of market forces are to be achieved. These regulatory solutions, no matter how cleverly crafted, never have their intended effect. Worse, they have the potential to perpetuate the distortions that decontrol is designed to eliminate.

Consumers will be protected by the free market, just as oil, coal, and electricity consumers are now protected. The market will dictate appropriate conservation investments, fuels choices and use levels for consumers. Consumers of oil have demonstrated their ability to adjust consumption habits to reflect higher unit prices. If gas prices rise, gas consumers will conserve and, if necessary, switch fuels. They will not helplessly continue to consume historic high levels of gas at higher prices.

The single group that must be assisted is low-income consumers. Low-income Americans cannot easily make conservation investments or fuels choices. Low-income oil and gas consumers should be assisted, at amounts in excess of current proposed levels, to help them pay the higher costs of energy. Such special programs can address the problem of the needy, but it is wrong to structure our entire national energy policy to meet the needs of this group. Natural gas policy should be established on the basis of sound principles that serve U.S. energy and security interests. Low-income consumers of all fuels should then be assisted to avoid undue hardship and sacrifice.

Conclusion

The Northeast Coalition supports full and prompt decontrol of natural gas prices. In the long term, it is clear that adequate supplies of energy at reasonable prices are generated most efficiently by market forces, rather than regulatory controls. In the short run, existing conditions in domestic and world energy markets guarantee a smooth transition to decontrol if accomplished promptly. The Northeast Coalition would also support the abrogation, or forced renegotiation of contracts, but only if accompanied by full decontrol. If Congress is unable to agree on a mechanism leading to prompt and full decontrol, contracts should not be abrogated, and no new regulatory scheme should be enacted. NGPA, with all its distorting effects, will provide a better path toward decontrol than any new and untried regulatory system.

The CHAIRMAN. Mr. Rosenthal.

STATEMENT OF GEORGE ROSENTHAL, PRESIDENT, FINK BAKING CORP., ON BEHALF OF THE INDEPENDENT BAKERS ASSOCIATION

Mr. ROSENTHAL. I am George Rosenthal, Mr. Chairman, president of the Fink Baking Corp., New York City.

I serve as chairman of the national affairs committee of the Independent Bakers Association and appear today in that capacity.

IBA is a national trade association comprised of independent small- and medium-sized wholesale bakers, most of which are family owned.

Collectively, our members produce nearly half the wholesale bread sold in the United States.

As we all know, natural gas users—industrial and residential alike—have seen their natural gas bills soar over the course of the past several years. Bakers who depend on natural gas for over 95 percent of their oven heating needs, have deeply felt the impact of the sharp gas price increase.

With natural gas accounting for at least 2 percent of the cost of a loaf of bread, the baking industry has been especially vulnerable to the outrageous gas price hikes, often as much as 50 percent in a single year.

The severe disruptions the natural gas market is currently undergoing stems from certain fundamental flaws in the Natural Gas Policy Act enacted by Congress in 1978.

The NGPA was designed to alleviate the chronic natural gas shortages experienced nationally during the winters of 1976-77 and 1977-78.

It encouraged producers to increase supplies by providing incentives to explore for and drill new wells. Although the NGPA succeeded in increasing natural gas supplies, it created a whole new set of problems that have caused domestic gas prices to spiral upward and totally disrupted the market.

In order to correct the chaotic U.S. natural gas market where demand is falling, supplies are increasing, and prices are still going up, IBA largely supports President Reagan's Natural Gas Consumer Regulatory Reform Amendment of 1983.

The President's proposal calls for the phased and total deregulation of all natural gas by January 1, 1985, to allow the free market to operate once again in the allocation of natural gas.

The orderly transition from a regulated to a deregulated market provided for in the plan will give all parties ample opportunity to adjust to deregulation.

Moreover, the administration's bill includes provisions to protect consumers during the transition period from any price increases not attributable to rises in real cost.

The cornerstone of the administration's deregulation plan is establishing a true free market price based on the average price of new and renegotiated contracts for natural gas.

Since under the proposed bill, these contracts would be freely signed in regard to both terms and price, the new free market contracts should reflect real market conditions.

In light of the current glut of natural gas suplies, the falling price of world oil and the depressed demand due to the recession, IBA anticipates that this free market price will be lower than the present regutated price.

The administration's proposal calls for using this free market price as a gas cap.

Under this unique gas decontrol scheme, ceilings will be placed on gas prices of contracts that are not renegotiated during the transition period. The ceiling will be based on the lower of either the NGPA-regulated price or the gas cap.

This will encourage producers and pipelines to renegotiate contracts. As an additional incentive to renegotiate as soon as possible after enactment, the bill provides that, as of January 1, 1985, any contract that has not been renegotiated, may be abrogated at the request of either party.

As mentioned previously, IBA believes that the renegotiation of contracts will result in lower natural gas prices and thus we support the Administration's provisions to encourage renegotiation.

The President's deregulation plan also gives the purchasers the option to reduce all take-or-pay contracts to 70 percent of deliverability until January 1, 1986.

Although IBA supports the general concept, we believe that 70 percent deliverability provides insufficient relief. Therefore, IBA proposes a 50 percent of deliverability level for a temporary period of three years.

We strongly support the immediate repeal of the Fuel Use Act and the incremental pricing program which interfere with the operation of the free market system.

The baking industry has become increasingly tied to natural gas for its heating needs due to the clean burning nature of natural gas.

Thus, bakers whose equipment is difficult to convert have been forced to endure the burden of the incremental pricing requirements unlike many other industrial users who have simply switched to other fuel sources.

The dramatic and unexpected cost of natural gas to incrementally priced users has had a devastating effect on independent bakers around the country.

Since incremental pricing has failed to significantly protect residential consumers from cost increases, IBA urges its repeal.

The IBA supports the consumer protection provisions of the proposal in the event that the natural gas prices rise due to deregulation. Prohibiting interstate pipelines from automatically passing through gas costs to consumers unless the additional costs are specifically approved by the Federal Energy Regulatory Commission will serve to protect consumers.

In addition to protecting consumers, it will also encourage pipelines to keep their total purchase gas cost down, thus further serving the interests of the consumer.

The proposal features other mechanisms to protect consumers from unnecessary price increases, namely, limiting price rises under escalator clauses to the level of the gas cap and requiring that pipelines take gas from itself or its affiliate at a rate no higher than its rate from others at cheaper prices.

These two provisions further insure that natural gas prices will be subject only to the free market and reflect real costs.

Although there is presently an abundant supply of natural gas, IBA proposes that new utilities—the electric utilities, particularly, should be banned from coming onto natural gas lines and significantly increasing the demand for natural gas.

We believe that this precaution would minimize shortages in the future. Those industries which are dependent on natural gas as a fuel source should be assured that supplies will be plentiful in years to come.

I would like to stress the fact that bakers cannot readily convert to alternative fuels as other industrial users can. Therefore, those users who have an inelastic demand for natural gas should have priority in receiving the gas, and steps should be taken to avoid jeopardizing their future supplies.

Overall, the President's legislation represents a broad political solution to the severe market disruptions caused by NGPA.

It addresses the widespread cries from both industrial and consumer groups over sky-high natural gas bills by providing regulatory relief as well as price protection.

IBA endorses the Natural Gas Consumer Regulatory Reform Amendment of 1983 with the minor exceptions of reducing all take-or-pay contracts to 50 percent of deliverability instead of the proposed 70 percent and adding protection for priority industrial users such as banning new utilities from coming onto natural gas lines.

Mr. CHAIRMAN. Mr. Rosenthal, your time has expired.

We have your entire statement. Thank you very much.

Mr. ROSENTHAL. Thank you so much.

[The prepared statement of Mr. Rosenthal follows:]

March 12, 1983

STATEMENT BY
GEORGE ROSENTHAL, CHAIRMAN
of the
NATIONAL AFFAIRS COMMITTEE
of the
INDEPENDENT BAKERS ASSOCIATION
before the
UNITED STATES SENATE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
NATURAL GAS

Mr. Chairman, my name is George Rosenthal. I am President of Fink Baking Corporation, an independent wholesale variety bakery located in Long Island City, New York. I serve as the Chairman of the National Affiars Committee of the Independent Bakers Association (IBA) and appear today in that capacity. IBA is a national trade association comprised of independent small and medium sized wholesale bakeries, most of which are family owned. Collectively our members produce nearly half the wholesale bread sold in the United States.

As we all know, natural gas users, industrial and residential alike, have seen their natural gas bills soar over the course of the past several years. Bakers, who depend on natural gas for over 95% of their oven heating needs, have deeply felt the impact of the sharp gas price increase. With natural gas accounting for at least 2% of the cost of a loaf of bread, the baking industry has been especially vunerable to the outrageous gas price hikes, often as much as 50% in a single year.

The severe disruptions the natural gas market is currently undergoing stems from certain fundamental flaws in the Natural Gas Policy Act (NGPA) enacted by Congress in 1978. The NGPA was designed to allieviate the chronic natural gas shortages experienced nationally during the winters of 1976-77 and 1977-78. It encouraged producers to increase supplies by providing incentives to explore for and drill new wells. Although NGPA succeeded in increasing natural gas supplies, it created a whole new set of problems that have caused domestic gas prices to spiral upward and totally disrupted the market.

In order to correct the chaotic U.S. natural gas market where demand is falling, supplies are increasing and prices are still going up, IBA largely supports President Reagan's Natural Gas Consumer Regulatory Reform Amendment of 1983. The President's proposal calls for the phased, total deregulation of all natural gas by January 1, 1985 to allow the free market to operate once again in the allocation of natural gas. The orderly transition from a regulated to a deregulated market provided for in the plan will give all parties ample opportunity to adjust to deregulation. Moreover, the Administration's bill includes provisions to protect consumers during the transition period from any price increases not attributable to rises in real cost.

The cornerstone of the Administration's deregulation plan is establishing a true free market price based on the average price of new and renegotiated contracts for natural gas. Since under the proposed bill, these contacts would be freely signed in regards to both terms and price, the new free market contracts should reflect real market conditions. In light of the current glut of natural gas supplies, the falling price of world oil and the depressed demand due to the recession, IBA anticipates that this free market price will be lower than the present regulated price.

The Administration's proposal calls for using this free market price as a "gas cap". Under this unique gas decontrol scheme, ceilings will be placed on gas prices of contracts that are not renegotiated during the transition period. The ceiling will be based on the lower of either the NGPA-regulated price or the "gas cap". This will encourage producers and pipelines to renegotiate contracts. As an additional incentive to renegotiate as soon as possible after enactment, the bill provides that as of January 1, 1985, any contract that has not been renegotiated, may be abrogated at the request of either party. As mentioned previously, IBA believes that the renegotiation of contracts will result in lower natural gas prices and thus we support the Administration's provisions to encourage renegotiation.

The President's deregulation plan also gives purchasers the option to reduce all "take-or-pay" contracts to 70% of deliverability until January 1, 1986. Although IBA supports the general concept, we believe that the 70% of deliverability provides insufficient relief. Therefore, IBA proposes a 50% of deliverability level for a temporary period of three years.

We strongly support the immediate repeal of the Fuel Use Act and the incremental pricing program which interfere with the operation of the free market system. The baking industry has become increasingly tied to natural gas for its heating needs due to the clean burning nature of natural gas. Thus bakers, whose equipment is difficult to convert, have been forced to endure the burden of the incremental pricing requirements unlike many other industrial users who have simply switched to other fuel sources. The dramatic and unexpected cost of natural gas to incrementally priced users has had devastating effects on independent bakers around the country. Since incremental pricing has failed to significantly protect residential consumers from cost increases, IBA urges its repeal.

IBA supports the consumer protection provisions of the proposal in the event that natural gas prices rise due to deregulation. Prohibiting interstate pipelines from automatically passing through gas costs to consumers unless the additional costs are specifically approved by the Federal Energy Regulatory Commission will serve to protect consumers. In addition to protecting consumers, it will also encourage pipelines to keep their total purchase gas cost down, thus futher serving the interests of the consumer.

The proprosal features other mechanisms to protect consumers from unnecessary price increase. Namely, limiting price rises under "escalator clauses" to the level of the "gas cap" and requiring that pipelines take gas from itself or its affiliate at a rate no higher than its rate from others at cheaper prices. These two provisions further insure that natural gas prices will be subject only to the free market and reflect real costs.

Although there is presently an abundant supply of natural gas, IBA proposes that new utilities should be banned from coming onto natural gas lines and significantly increasing the demand for natural gas. We believe that this precaution would minimize shortages in the future. Those industries which are dependent on natural gas as a fuel source should be assured that supplies will plentiful in the years to come. I would like to stress the fact that bakers cannot readily convert to alternative fuels as other industrial users can. Therefore, those users who have an inelastic demand for natural gas should have priority in receiving the gas and steps should be taken to avoid jeopardizing their future supplies.

Overall, the President's legislation represents a broad political solution to the severe market disruptions caused by NGPA. It addresses the widespread crys from both industrial and consumer groups over sky-high natural gas bills by providing regulatory relief as well as price protection. IBA endorses the Natural Gas Consumer Regulatory Reform Amendment of 1983 with the minor exceptions of reducing all "take-or-pay" contracts to

50% of deliverability instead of the proposed 70% and adding protection for priority industrial users such as banning new utilities from coming onto natural gas lines.

We respectfully urge Congress to consider the President's legislative proposal and to take immediate action to tackle this contoversial, pressing issue. The inherent flaws in NGPA must be corrected expediently. Lengthy debates should be avoided in forging compromise legislation to insure that measures are taken to stabilize the natural gas market by this winter. The key to rectifing the current distortions lies in providing real and long-term incentives to produce and market gas supplies at the lowest possible cost. This can be achieved through the phased, deregulation of natural gas as put forth in the President's bill.

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The **CHAIRMAN**. Mr. Fonville.

STATEMENT OF DONALD FONVILLE, RICHMOND UNITED NEIGHBORHOODS

Mr. **FONVILLE**. Mr. Chairman.

I appreciate this opportunity to testify before this panel at this time.

My name is Donald Fonville. I am representing Richmond United Neighborhoods in Richmond, Va.

As a result of decontrol of natural gas prices, citizens of this country have seen an increase in our gas bills on a steady basis.

There are those of us who have tried to combat these high costs by conservation, and by turning back thermostats and even closing off rooms, to name a few.

In spite of all our efforts, our gas bills continue to go higher. The following sentences are quoted directly from a brochure from the Richmond Department of Public Utilities.

> An unfortunate effect of life is that the cost of natural gas is continuing to increase. This is largely a result of the Natural Gas Policy Act of 1978, which allows gas producers to increase the price of gas through 1985 in phases.
>
> We would like to take this opportunity to provide you, as customers, with as much information as possible regarding the expected cost of natural gas so that you can better plan for these increases.
>
> According to our best estimates, we expect a 30 percent increase in our costs over last year for the current heating season. This increase in the cost of purchase gas from our suppliers is passed directly to you without adding any charges.

This news comes after our bills have already more than doubled. In 1977 the average yearly bill for a single family using natural gas in Richmond was $384. In 1982 the average single family in Richmond used $677 worth of natural gas. This comparison is with the same volume of cubic feet.

These bills are generating much concern, fear, and hardship. Since January 1, 1983, in Richmond, over 1,200 customers of natural gas have had their gas service cut off because of their inability to pay their bills.

As our costs go up and up, gas producers' pockets escalate. In 1970, out of every dollar spent for natural gas, 26 cents went to the producer, 29 cents went to the pipeline, and 45 cents went to the utility company.

According to the Commonwealth Gas Pipeline in 1982, out of every dollar Richmond consumers paid for natural gas, 66 cents went to the producer, 17 cents went to the pipeline, and 17 cents went to the utility company.

At the congressional hearing on natural gas prices last Monday, Geneva Whit from Council Bluffs, Iowa, gave the following testimony:

> We have been held captive by big oil. This point was made by Mardy McAlpine, an independent gas producer at a hearing on January 31, 1983, in Des Moines.
>
> The FERC Commissioner, Oliver Todd, Mr. McAlpine said that the big oil was not interested in pushing their own natural gas until the Natural Gas Policy Act was passed, and now if we don't drill with the big oil companies, you won't have a gas contract.
>
> In his own words, quote, "They, the big oil companies, own the natural gas industry."
>
> Our research shows that only 18 oil companies produce 51 percent of the natural gas and oil and control 60 percent of the natural gas reserves in the country. A

survey of these 18 oil companies reveal that since decontrol began in 1978 their after-tax profit rose 100 percent, from $44 billion in 1974 to $88 billion in 1977 to 1981.

We have been told that decontrol will result in lower gas prices. We have experienced the opposite. Since where decontrol began in 1978, the price of natural gas has escalated to astronomical figures.

History has taught us that a greedy man, given a free hand, will eat more of the pie, not less of it. The big winner with decontrols is the oil company.

Richmond United Neighborhoods is a member of the National People's Action. We have learned in meetings with National People's Action leadership that the following prices exist throughout the country, as a direct result of higher gas prices.

Businesses are being forced to close. Businesses have had to lay off. Retailers increased their prices of their goods to their consumers. Churches and other institutions have had to curtail services and the use of their facilities.

Charitable organizations have had to suspend some of their services to the poor and needy. Property owners increased their rent, which caused hardship on their tenants. And senior citizens and others on fixed incomes have had to choose between heating and eating.

The price of natural gas has become a national crisis. It is within your power to relieve the hardship that has been caused by the Natural Gas Policy Act.

We are asking Senator Warner or one of you, his fellow Senators, to introduce Congresswoman Cardiss Collins' bill, H.R. 2012 in the Senate. Ms. Collins' bill will roll back prices and put price controls on all categories of natural gas.

It will eliminate take-or-pay contracts, require pipelines to purchase the cheapest gas available and outlaw automatic price increases to consumers.

The bill also makes provisions for weatherization and provides fuel assistance for those in need.

According to Gail Sincarter, chairperson of the National People's Action, if the Collins legislation were passed today, it would see an immediate savings in the pockets of consumers.

Wellhead prices would be rolled back 60 percent, which would result in at least a 33-percent savings in the average gas bill for the people across this country.

Before you vote on legislation on natural gas, I would suggest that you hold public hearings in cities where you made your campaign speeches, and hear from the people whom you represent.

Everyone cannot come from Washington. While it is easy for the oil companies to get here, it is financially impossible for many of your constituents to come.

The problem we face is a matter of survival. We are asking that you listen to us and then make your decision. I would like to reemphasize Richmond United Neighborhood's support of Congressman Cardiss Collins' bill. We need control on natural gas prices.

With me I have a testimony that was presented in the congressional hearing on March 3, 1983, from Mr. Thomas Fiden, who is the engineer of the St. Mary's Hospital in Richmond. I would like this entered on your——

The CHAIRMAN. We will make it a part of the record at this point, Mr. Fonville.

Mr. FONVILLE. Thank you.

[The prepared statements of Mr. Fonville and Mr. Fiden follow:]

RICHMOND UNITED NEIGHBORHOODS
19 OVERBROOK ROAD
RICHMOND, VIRGINIA 23222
804-321-2566

TESTIMONY ON NATURAL GAS PRICES

Senate Hearing
March 12, 1983

MY NAME IS DONALD FONVILLE. I AM REPRESENTING RICHMOND UNITED NEIGHBORHOODS, IN RICHMOND, VIRGINIA. I'VE COME TO REGISTER OUR COMPLAINT CONCERNING THE NATURAL GAS POLICY ACT PASSED BY CONGRESS IN 1978. AS A RESULT OF DECONTROL OF NATURAL GAS PRICES CITIZENS OF THIS COUNTRY HAVE SEEN AN INCREASE IN OUR GAS BILLS ON A STEADY BASIS. THERE ARE THOSE OF US WHO HAVE TRIED TO COMBAT THESE HIGH COSTS BY WEATHERIZATION, TURNING BACK THERMOSTATS, AND EVEN CLOSING OFF ROOMS TO NAME A FEW. IN SPITE OF ALL OF OUR EFFORTS, OUR GAS BILLS CONTINUE TO GO HIGHER.

THE FOLLOWING SENTENCES ARE QUOTED DIRECTLY FROM A BROCHURE FROM THE RICHMOND DEPARTMENT OF PUBLIC UTILITIES; "AN UNFORTUNATE FACT OF LIFE IS THAT THE COST OF NATURAL GAS IS CONTINUING TO INCREASE. THIS IS LARGELY A RESULT OF THE NATURAL GAS POLICY ACT OF 1978 WHICH ALLOWS GAS PRODUCERS TO INCREASE THE PRICE OF GAS THROUGH 1985 IN PHASES. WE WOULD LIKE TO TAKE THIS OPPORTUNITY TO PROVIDE YOU, OUR CUSTOMERS, WITH AS MUCH INFORMATION AS POSSIBLE REGARDING EXPECTED COSTS OF NATURAL GAS SO YOU CAN BETTER PLAN FOR THESE INCREASES. ACCORDING TO OUR BEST ESTIMATES, WE EXPECT A 30 PERCENT INCREASE IN COST OVER LAST YEAR FOR THE CURRENT HEATING SEASON. (THIS INCREASE IN THE COST OF PURCHASED GAS FROM OUR SUPPLIERS IS PASSED DIRECTLY TO YOU WITHOUT ADDING ANY OTHER CHARGES.

THIS NEWS COMES AFTER OUR BILLS HAVE ALREADY MORE THAN DOUBLED. IN 1977 THE AVERAGE YEARLY BILL FOR A SINGLE FAMILY USING NATURAL GAS IN RICHMOND WAS $382. IN 1982 THE AVERAGE SINGLE FAMILY IN RICHMOND USED $677 OF NATURAL GAS.

THESE BILLS ARE GENERATING MUCH CONCERN, FEAR, AND HARDSHIP. SINCE JANUARY 1, 1983 IN RICHMOND, OVER 1,200 CUSTOMERS OF NATURAL GAS HAVE HAD THEIR GAS SERVICE CUT OFF BECAUSE OF THEIR INABILITY TO PAY THEIR BILLS.

AS OUR COSTS GO UP AND UP, GAS PRODUCERS' PROFITS ESCALATE. IN 1970 OUT OF EVERY DOLLAR SPENT FOR NATURAL GAS 26¢ WENT TO THE PRODUCER, 29¢ WENT TO THE PIPELINE AND 45¢ WENT TO THE UTILITY COMPANY. ACCORDING TO COMMONWEALTH GAS PIPELINE IN 1982 OUT OF EVERY DOLLAR RICHMOND CONSUMERS PAID FOR NATURAL GAS, 66¢ WENT TO THE PRODUCER, 17¢ WENT TO THE PIPELINE AND 17¢ WENT TO THE UTILITY COMPANY.

AT THE CONGRESSIONAL HEARING ON NATURAL GAS PRICES LAST MONDAY, GENEVA WREDT FROM COUNCIL BLUFFS, IOWA GAVE THE FOLLOWING TESTIMONY: "WE'RE BEING HELD CAPTIVE BY BIG OIL. THIS POINT WAS MADE BY MARTY MC ALPINE (AN INDEPENDANT GAS PRODUCER) AT A HEARING ON JANUARY 31ST, 1983, IN DES MOINES, WITH FERC COMMISSIONE OLIVER RICHARD. MR. MC ALPINE SAID, THAT BIG OIL WAS NOT INTERESTED IN PRODUCING THEIR OWN NATURAL GAS UNTIL THE NATURAL GAS POLICY ACT WAS PASSED AND NOW IF YOU DON'T DRILL WITH THE BIG OIL COMPANIES, YOU WON'T HAVE A GAS CONTRACT. IN HIS OWN WORDS, QUOTE, THEY (THE BIG OIL COMPANIES) OWN THE NATURAL GAS INDUSTRY."

OUR RESEARCH SHOWS THAT ONLY 18 OIL COMPANIES PRODUCE 51% OF THE NATURAL GAS AND CONTROL 60% OF THE NATURAL GAS RESERVES IN THE COUNTRY. A SURVEY OF THESE 18 OIL COMPANIES REVEALED THAT SINCE DECONTROL BEGAN IN 1978, THEIR AFTER TAX PROFITS ROSE 100% — FROM $44 BILLION IN 1974 TO 1977, TO $88 BILLION IN 1978 TO 1981.

WE HAVE BEEN TOLD THAT DECONTROL WILL RESULT IN LOWER GAS PRICES. WE HAVE EXPERIENCED THE OPPOSITE. SINCE GRADUAL DECONTROL BEGAN IN 1978 THE PRICE OF NATURAL GAS HAS ESCALATED TO ASTRONOMICAL FIGURES. HISTORY HAS TAUGHT US THAT A GREEDY MAN GIVEN A FREE HAND WILL EAT MORE OF THE PIE, NOT LESS OF IT. THE

BIG WINNER WITH DECONTROL IS THE OIL COMPANY.

RICHMOND UNITED NEIGHBORHOODS IS A MEMBER OF NATIONAL PEOPLES' ACTION. WE HAVE LEARNED IN MEETINGS WITH NATIONAL PEOPLES' ACTION LEADERSHIP THAT THE FOLLOWING CRISIS EXISTS THROUGHOUT THE COUNTRY AS A DIRECT RESULT OF HIGHER GAS PRICES: BUSINESSES ARE BEING FORCED TO CLOSE; BUSINESSES HAVE HAD HUGE LAYOFFS; RETAILERS INCREASED THE PRICES OF THEIR GOODS TO THE CONSUMERS; CHURCHES AND OTHER INSTITUTIONS HAVE HAD TO CURTAIL SERVICES AND THE USE OF THEIR FACILITIES; CHARITABLE ORGANIZATIONS HAD TO SUSPEND SOME OF THEIR SERVICES TO THE POOR AND NEEDY; PROPERTY OWNERS INCREASED THEIR RENT WHICH CAUSED HARDSHIP ON THEIR TENANTS; AND SENIOR CITIZENS AND OTHERS ON FIXED INCOME HAVE HAD TO CHOOSE BETWEEN HEATING AND EATING.

THE PRICE OF NATURAL GAS HAS BECOME A NATIONAL CRISIS. IT IS WITHIN YOUR POWER TO RELIEVE THE HARDSHIP THAT HAS BEEN CAUSED BY THE NATURAL GAS POLICY ACT. WE ARE ASKING SENATOR WARNER OR ONE OF YOU, HIS FELLOW SENATORS, TO INTRODUCE CONGRESSWOMAN CARDIS COLLINS' BILL, HR 2012, IN THE SENATE. MRS. COLLINS' BILL WOULD ROLL BACK PRICES AND PUT PRICE CONTROLS ON ALL CATEGORIES OF NATURAL GAS. IT WOULD ELIMINATE TAKE OR PAY CONTRACTS, REQUIRE PIPELINES TO PURCHASE THE CHEAPEST GAS AVAILABLE AND OUTLAW AUTOMATIC PRICE INCREASES TO CONSUMERS. THE BILL ALSO MAKES PROVISIONS FOR WEATHERIZATION AND FUEL ASSISTANCE FOR THOSE IN NEED.

ACCORDING TO GALE CINCOTTA, CHAIRPERSON OF NATION PEOPLES' ACTION: "IF THE COLLINS' LEGISLATION WERE PASSED TODAY WE WOULD SEE IMMEDIATE SAVINGS IN THE POCKETS OF CONSUMERS. WELLHEAD PRICES WOULD BE ROLLED BACK 60%, WHICH WOULD RESULT IN AT LEAST A 33% SAVINGS IN THE AVERAGE GAS BILL FOR PEOPLE ACROSS THE COUNTRY."

BEFORE YOU VOTE ON LEGISLATION ON NATURAL GAS I WOULD SUGGEST THAT YOU HOLD PUBLIC HEARINGS IN CITIES WHERE YOU MADE YOUR COMPAIGN SPEECHES AND HEAR FROM THE PEOPLE WHOM YOU REPRESENT. EVERYONE CAN NOT COME TO WASHINGTON. WHILE IT IS EASY FOR THE OIL COMPANIES TO GET HERE IT IS FINANCIALLY IMPOSSIBLE FOR MANY OF YOUR CONSTITUENTS TO COME. THE PROBLEMS WE FACE ARE A MATTER OF SURVIVAL. WE ARE ASKING YOU TO LISTEN TO US AND THEN MAKE YOUR DECISION.

I WOULD LIKE TO RE-EMPHASIZE RICHMOND UNITED NEIGHBORHOODS' SUPPORT OF CONGRESSWOMAN COLLINS' BILL. WE NEED CONTROLS ON NATURAL GAS PRICES.

St. Mary's Hospital
Richmond, Virginia 23226
March 3, 1983

I'm Tom Fiden, the Director of Engineering at St. Mary's, a 369-bed, not-for-profit, acute care hospital in Richmond, Virginia. As such, one of my responsibilities is to budget for the cost of utilities such as electricity, fuel oil and natural gas. It's also my responsibility to maintain records of the use and cost of these utilities (which can be combined under the general term of energy), to report to management concerning use and cost and to contain use and cost of these items as much as possible.

Obviously, there is significant concern and interest in energy use and cost because of its impact upon the cost of health care, which has been under continual congressional scrutiny and analysis within the past several years. The Tax Equity and Fiscal Responsibility Act of 1982 has provisions affecting Medicare and Medicaid that basically legislate cost reductions through per-case and perspective reimbursement. Increases in the cost of energy that are not within the control of the hospital are naturally a very serious matter, and the dramatic increase in the cost of fuel oil a couple of years ago is now being followed by an even more dramatic increase in the cost of natural gas.

I've put together a table that indicates energy use and cost for the past four years. It shows that we have been successful in reducing energy use during that period (3% in 1980, 7% in 1981 and 3% in 1982). Part of that success is due to the fact that we have participated in the Institutional Conservation Program for Schools and Hospitals sponsored by the federal government, and in which we have expended over $150,000 to match federal sharing funds of about $150,000.

But all of our efforts to date to reduce energy costs by reducing usage have been negated by the continual rise in the cost of energy. Since 1979 electricity is up a modest 26% when compared to fuel oil at 119% and natural gas at 127%. Combining all of these energy sources results in a 56% increase overall. Considering the fact that a semi-private room has only risen 36% in the past four years (I use the term "only" reluctantly) it's obvious that the cost of energy must be contained or the cost of a semi-private room and other health care services will go up. It appears to me that the plan to decontrol the price of natural gas with the subsequent increase in cost (the effect already apparent between 1981 and 1982 when the increase went from a 48% increase to 127%) is in direct conflict with the other federal efforts mentioned to contain costs.

I, therefore, recommend that the control of natural gas be continued and that a price cap be placed on all categories of gas. I believe that this is the only way that prices will be stabilized and still provide the incentive for exploration. My confidence in the ability of market forces to contain or reduce costs after complete decontrol is not high based on the example of fuel oil and 1982's gas costs.

ST. MARY'S HOSPITAL

ENERGY USE AND COSTS

	1979	1980	1981	1982
Total Energy Used - MBTU	146,287	142,221	136,062	141,199
Use Change with Respect to 1979		-3%	-7%	-3%
Cost Change per MBTU with Respect to 1979		+33%	+26%	+56%
ELECTRICITY				
Cost Change		+25%	+19%	+26%
FUEL OIL				
Cost Change		98%	116%	119%
NATURAL GAS				
Cost Change		45%	48%	127%
Cost of a Semi-Private Room	$99	$122	$125	$135
Cost Change		+23%	+26%	+36%

The CHAIRMAN. Mr. Buckley, you have attached to your statement a number of studies that support the thesis that competition will benefit the consumer?

Mr. BUCKLEY. That is correct.

The CHAIRMAN. And one of the studies—I believe the one made by the Madison consulting group—concluded that home heating oil prices would go down if natural gas prices are decontrolled.

Upon what basis was that conclusion reached?

Mr. BUCKLEY. Well, basically, Mr. Chairman, we, as you know, have a couple of trillion cubic feet of natural gas shut in right now. It is old gas. It is not $1 gas, or $2 gas. It is 20-cent or 50-cent gas. It is the kind you don't produce, if someone has a take-or-pay to take new deregulated deep gas.

But if you decontrol natural gas so that it would compete with oil, then the producers of that gas—and my friend from Richmond is right—it is mostly the major oil companies, 22 out of the top 25 producers of natural gas are oil companies, most of the household names that you know.

Those oil companies faced with an alternate for the first time in 30 years are being able to produce their own natural gas and sell it at a market-clearing price slightly under oil, as they will take the market or the alternative of bringing in foreign oil which they used to own, but no longer own—it is now owned by producing countries. They don't make any money on it, and they often lose money on it.

They are not going to bring in the oil; they are going to produce their own gas, and they are going to sell it in this market, and they are going to back out oil, probably 1 million barrels a day within a couple of years.

How does oil compete with that? Well, oil, as you know, is in a very weak situation. Now, here and internationally, and so what happens when you get that new competition and lower imports in the United States is further downward pressure on OPEC, on world prices generally accelerating, the trend that is already in existence, and so we see lower oil prices as well as these two fields go head to head.

And obviously the consumer benefits from that.

The CHAIRMAN. Mr. John McMillian, the president of the Northwest Pipeline Co., who serves the Pacific Northwest, testified that with the passage of this legislation the consumer price in the region would go up.

The conclusion of the Harvard study, as well as the Madison study, is that prices in the area would go down; is that correct?

Mr. BUCKLEY. I believe so, because I think what has happened in the Pacific Northwest is that the region has become a fairly, to a high degree, dependent on Canadian imports, and Canadian imports are not market price. They are politically priced. Canada is making all the mistakes in the eighties that we made in our energy policy in the seventies, and they are reaping the whirlwind from it right now, just as we did, in the form of higher prices.

But with decontrol, and with surplus—what is now surplus or shut-in natural gas domestically, you will see more of the lower cost domestic oil-gas flowing in that area and true competition. Right now, as you know, oil is cheaper than gas in those States, and most of the pulp and paper mill and forest product companies have gone back to oil; and Canada has just been losing that market.

I think that domestic producers of gas, under decontrol, will be far more effective competitors than Canadian gas is.

The CHAIRMAN. Senator Ford.

Senator FORD. Thank you, Mr. Chairman.

Mr. Rubin, you said the National Association of Manufacturers' resolution generally—and I got the word "generally"—support the administration's bill.

What is it that you don't like?

Mr. RUBIN. There isn't anything specifically right now that we don't like, but there are some matters that we are looking at, to see whether or not there could be some changes suggested to make it more workable.

We like the balance, Senator Ford, protecting the consumers while we arrive at a free market. We are having a study done now by the staff which we will be going over as a committee shortly, looking at such issues as whether the limitation on passthrough or the cap—the way they are in the bill may end up inhibiting renegotiation of contracts.

And so those are two of the issues we are looking at. There are several more issues we are looking at too regarding various abrogations of contracts.

Senator FORD. Under the administration's proposal, there are three sections—the distribution system which has a form of control over it, which is the public service commission or public utility commission of a State.

Under this piece of legislation, S. 615, the pipelines are controlled, and that is not a free market. It just says you can't pass through anything other than 4 percent inflation, or 5 percent, so you have got controls on pipelines; so there is no free market there.

But yet you have no controls on the producers. You are going to deregulate that. Are you in agreement? Or is that one of the areas in which you have some concern with?

Mr. RUBIN. Well, Senator, I am not sure that I agree with your analysis of what the bill does.

First of all, controls on pipelines that you are talking about, I assume, are the passthrough—PGA passthrough.

Senator FORD. Correct.

Mr. RUBIN. And those are transitional controls.

There are also continued controls on the producers for that same period of time. There are no markets out between now and January 1, 1985, unless both parties to the contract agree to it.

And caps remain in effect, it is my recollection, until January 1, 1986, unless the contracts have been renegotiated. So, I believe that there are limitations on the producers as well as on the pipelines under this bill.

Senator FORD. January 1, 1985, either member can break the contract.

Mr. RUBIN. That is what I said, but—and after January 1, 1986, the pipelines are not bound by the passthrough limitation.

Senator FORD. Yes, but then they have to file for their rate.

Mr. RUBIN. With FERC.

Senator FORD. They have to go to a rate file with FERC.

Mr. RUBIN. I understand that.

Senator FORD. Yes; so that is regulation.

Mr. RUBIN. That is continued regulation.

Senator FORD. Continued.

Mr. RUBIN. And there is a prudency test in this bill, too, where FERC would review the purchasing arrangements that the pipelines were making with the producers.

Senator FORD. So, we are not getting out from under regulation as such, even with this piece of legislation however, grandiose some people might think it is.

Mr. RUBIN. But what we are doing is that we are addressing the continued controls at the wellhead, and the price disparities amongst the various regions.

One of the problems that——

Senator FORD. There is always going to be price disparities among regions if the product is in Texas and you have to get it to Boston. And the product is there, and you have to get it to Louisville, Ky., because the transportation is going to vary.

You cannot expect a pipeline to carry it for the same price to Boston, as Mr. Buckley will understand, as you will to Louisville.

And if you are going to make them common carriers, then you just give them an opportunity to pass it through, and you will make the deal with Louisville, and they will be required then to transport it for you at unit cost which is fair and reasonable, and then they become regulated again.

Mr. RUBIN. But, Senator, the—my understanding of what the producers want to do is to make money, and the only way they are going to do that is by selling their gas. They are not going to be able to sell it at the price that is too high to compete with Mr. Weber and Mr. Buckley, so at the burner tip there is going to be competition, and how it gets to that point is going to have to be a matter of negotiation between the pipelines and the producers.

Senator FORD. I find Mr. Buckley to be very honest—22 oil companies own about 80 percent of natural gas. They are in the dual business. So, if they are selling you oil and they are selling you natural gas, they have you going and coming.

And they have 70 to 80 percent of the old gas, which is a very low-cost gas, that is holding the prices down now. When you deregulate that, there is no incentive, as Mr. Murray said, to go out and try to find new gas, because you have really a windfall.

And no one has disputed somewhere between $40 and $60 billion increase in income by the virtue of the fact you deregulate old gas, and that goes to the majors—roughly 20 of the majors, and they are the ones who get the profit. Can you deny that?

Mr. RUBIN. I am not sure what effect it has at arriving at a free market, as to whom the money goes to.

Senator FORD. Well, arriving at a free market, Mr. Davis, I think, was here today, and he has done a prudent job. I kind of liked him because he had 70 percent of his distribution—that is old gas; 2 percent from Canada, and he has done a pretty good job. He had market-out. He showed he had some good judgment—28 percent of the other.

So, when we deregulate all this, you know, the pipeline has 70 percent of the high cost gas, you have really damaged Mr. Davis, and as Mr. Buckley said, total deregulation.

Well, if you don't have total deregulation of all contracts, you don't have total deregulation. And then you are going to have financial chaos. That is exactly what you are going to have among that total industry, and the only ones who are going to be able to waddle through are the big oil companies who have plenty of money, those that can survive, in my opinion. You are going to see the little fellows that have been in business all these years, that are not really little in comparison to a dollar—they will probably have millions of dollars of income.

But I can see them going down the drain, basically, on what we are doing here, deregulating that old gas.

Mr. RUBIN. Right now, under the NGPA, Senator, we find a number of our companies, a number of members of NAM whose competitive advantage or disadvantage is not dependent upon their efficiency but upon what pipeline they are on.

And continuation under the controls of the NGPA are just exacerbating that. That is one of the main reasons that we want to get to a free market and let demand determine the price, and not let the Government regulations determine the price.

Senator FORD. Well, Mr. Rubin, you want to get back to the dual system of intrastate pipeline, interstate pipeline because on January 1, 1985, when they cancel those contracts, they can shift just a smidgen over the interest cap, and put it into intrastate. We get back to the same problem we had when the political atmosphere was such that we tried to eliminate the—one Governor said, "I'm going to put a National Guardsman every 5 feet around part of this State—you come and get it."

You know, we heard that. We had that kind of threat when we were here, trying to get the gas up to Boston, trying to get it up to Ohio, trying to get it up to Kentucky, to the consumer States. That was a different political atmosphere than we have today.

We have got an economic problem today—economic problem in 1976 and 1977, and 1977-78 was that workers couldn't work—we had an opportunity to give them work, but we didn't have gas to run the operation.

We tried to get it in so they could go to work. Now, we find it so high they are out of work, can't go to work. It doesn't make any difference if you lower the price, some of them couldn't pay it anyhow.

Do you agree with that? National Association of Manufacturers ought to feel a littte bit, about 30 percent of the market—only 70 percent of production.

Mr. RUBIN. Well, Senator, I am not certain that there is not a dual market under the present system as well, and our hope would be that eventually we would get to deregulation and it would be the marketplace determining the price, and we have—we have heard of situations where a purchaser of natural gas in Texas is buying the natural gas from a distributor in the Midwest, having it transported from Texas up to the Midwest and then paying to bring it back down to Texas, and if that turns out to be cheaper because of regulations than buying from a Texas field.

So, we have got all kinds of inequities going on right now.

Senator Ford. Mr. Rubin, if that is based on regulation, then the gas that is coming back to Texas is old gas, which reduces the price, and if you listened to Mr. Murray a few moments ago, his fear is not whether you reduced price or deregulated, what he is worried about is the incentive to go out and find more gas.

And he is concerned, as others are, that once the economy gets back, regardless of what administration it is in, the country is big enough to respond and it will.

And so, at some point in time, we are going to start responding, and when we do respond we are going to be calling for more oil, more natural gas, and more everything else, hopefully.

So, then, if you have a shortage, the price is going back up. I think there is more chaos with the price coming down than there were with prices going up, because at least we were working when prices were going up.

Mr. Rubin. Senator, I don't have the same expert knowledge, but I have talked to a lot of producers whose major concern for new production is certainty. The major concern is the uncertainty that we have today.

We have an NGPA, and we have cries for recontrol of prices, for rollback of prices, for freezes; there is all this uncertainty.

And it seems to me that for most of the producers, including the independents, they will be much more happy to have a deregulated market, know what is going on, and be able to operate under it.

Senator Ford. I know my time is up, but I wanted to get hold of Mr. Buckley for a minute, if I could.

Mr. Buckley. I was afraid of that.

Senator Ford. Mr. Buckley, in your statement, you talk about synthetic natural gas. Where is that coming from?

Mr. Buckley. Synthetic natural gas in our region, Senator, is manufactured from naphtha or something similar to gasoline, so it is very, very costly, and we have a synthetic natural gas plant in Massachusetts that can run about 30,000 barrels a day of oil and convert it to naphtha, and it is used for peak loading in the winter.

Senator Ford. There are some synthetic fuels then available out there in case we have a shortage. At least there is some work being done in that field in your area.

Mr. Buckley. Yes, there is a plant that has been in operation now for several years. It just converts petroleum hydrocarbon to gas hydrocarbon.

Senator Ford. You said decontrol of the airlines, decontrol of the buslines, decontrol of the trucking industry and all that, I understood you in your statement.

Name one of those that has been decontrolled where the price has gone down.

Mr. Buckley. Oil.

Senator Ford. Oil is there because of the economy, because there is only 70 percent of the economy working. You know that as well as I do.

Mr. Buckley. I totally disagree, Senator. Our economy is bigger today than it was 2 years ago. It has not been growing very fast, and we have had some static years, but it is certainly larger today than it was then and much larger than it was in 1978 when the embargo and the fall of the Shah really drove up the prices.

What you have to understand is that it is not the economy; what has happened is a permanent structural change toward energy efficiency.

That is not going to change whether the price of oil is 50 cents a gallon or a dollar, as it is today, or 96 cents for regular gasoline instead of $1.25.

Once you put that insulation in, you don't rip it out. Once industry makes 100 investments in energy efficiency, they are there year after year.

Our average industrial customer—and we supply some 250 of the largest manufacturers in New England—is down 40 percent in the last 4 to 5 years in oil use, even though their capacity is some 10 to 12 percent larger than it was then.

Our average home is down over 40 percent. And I am talking about homes that still burn oil, not ones that converted to gas because the gas companies were handed an artificial price advantage by the Government.

No, sir, these changes are structural changes in the use of energy. You see it in the automotive sector, in the industrial, commercial and residential sector, and it is not going to change with our fast-growing economy.

If you get a 5 percent GNP growth in the fourth quarter of this year, you might see oil use go up 1 percent, and that is not going to change OPEC's problem, not this century.

Senator FORD. Well, you are the first person who has been willing to project beyond tomorrow or this year. Mr. Butler was here and he wouldn't project more than the next day.

He wouldn't even go the next 6 months. So you are talking about into the next century. You had better—they need you downtown, and badly, I might say.

When did decontrol of oil start?

Mr. BUCKLEY. 1976. In May residual fuel, industrial fuel, was decontrolled. June of 1976 heating oil was decontrolled.

Mr. Carter starting decontrolling crude oil. President Reagan finished decontrolling crude oil and gasoline in the first week in office in January 1981.

Senator FORD. Now what was the price of oil when he started decontrol under Carter?

Mr. BUCKLEY. 1970—well——

Senator FORD. What was the cost?

Mr. BUCKLEY. When he started decontrol, the bill that was passed was passed before the Shah fell, so when it really started, the price was——

Senator FORD. What was the——

Mr. BUCKLEY [continuing]. Skyrocketing by OPEC.

Senator FORD. What was the price of oil when Carter started to decontrol?

Mr. BUCKLEY. I would have to look up the month. It was generally in the area of——

Senator FORD. Well, let me just ask you this question: wasn't it lower then than it is now?

Mr. BUCKLEY. Oh, it was lower then than it is now, no question.

Senator **Ford**. Everything that has been deregulated has gone up, including oil.

Mr. **Buckley**. When he started, as you remember, it was a very small percertage per month. It was basically a controlled product and not a decontrolled product.

When you decontrol something at 3 percent or 4 percent a month for 39 months, the first 2 or 3 months it is not decontrol, it is still basically control.

When President Reagan decontrolled in January, the price went up 10 cents in one month, a gallon. That is $4 a barrel.

And then what happened? Companies found out people weren't buying, and they still had the oil and they had to sell it, so they started lowering the price.

And every successive quarter since that time, January of 1981, the refiner acquisition cost of this industry has gone down—every single quarter through two simultaneous wars in the Middle East, with the kind of disruptions that used to cause panic, the price continued to go down, and it is going to continue to go down.

Senator **Ford**. And every quarter the unemployment went up. Thank you, Mr. Chairman.

The **Chairman**. Thank you. Senator Hecht?

Senator **Hecht**. Senator Ford, thank you for taking some of the time. I thought that was one of the best dissertations on the free enterprise system I have ever heard. Very well said.

You urge immediate deregulation, not a phaseout, Mr. Buckley, as you state it, not a phaseout by 1985. Will you comment on that, please.

Mr. **Buckley**. Well, I think basically, Senator, you have to realize that with oil prices where they are right now today, if you could decontrol natural gas tomorrow, over the next month or two you might see the same kind of rise Mr. Reagan did—10 percent.

And a clearing price for natural gas today would be about $3.20, $3.25 a thousand cubic feet, and it is currently at about $3, if you are weighing the high cost and the low cost and the in-between cost.

So you will see a little bit of a ripple upward—maybe 10 percent—just like oil. And a lot of people hollering and screaming about contracts, but when you come right down to it, the market will settle those contracts in a matter of months because if you are going to have to take some stuff that you can't sell, within a week or two your DTU is going to tell you you better get out of that contract, just the way they did in southern California.

They said get rid of that Canadian gas, and the gas utilities said, we can't, it is a long-term contract, you are endangering our supply, and the DTU said get rid of it, and it is gone.

You know, I can't take, I won't pay, sue me. What is a producer going to do: spend all his time on lawsuits or is he going to want to sell his gas?

They will get with that market. It has been a long time since they have been in one—almost 30 years. We had petroleum with pervasive controls for a decade, and it took a month after decontrol for that market to start working.

A lot of us have been hurt. A lot of us are making an awful lot less money or losing money. My company lost money last year. So why am I here arguing for decontrol?

We never had it so good when we had controls because there was no competition. They told us who to buy from, they told us how much to pay, they told us who to sell to, they told us how much we could sell for, and there was a fat profit built in there because the least efficient were protected, and those who were more efficient made money.

Now that would happen in gas just as well. Those contract problems would disappear in the market. I don't believe you even need to tell them what to do or how to change their contract.

If you are in the business of producing and you want to produce, you are going to find someone who will buy. And if you have a contract that doesn't let that happen, you will change it.

Senator HECHT. Thank you very much.

The CHAIRMAN. Gentlemen, thank you very much for your testimony. I think the testimony and the response to it may prove the old adage: you may be the last, but you are not necessarily the least.

Thank you very much for your testimony and your courtesy and your patience in waiting for the opportunity to present it to us today.

Written questions may be submitted to members of the panel by any member of the committee. We will receive those and transmit them any time through the close of business on Tuesday.

We will include the replies in the record when received.

Senator FORD. Mr. Chairman, this Operational Economics, Inc., had a statement here, and if anybody believes in computer models, early deregulation would bring it from presentday prices of wellhead of $2.45 to 1990 of $4.66, if you believe the computer model.

The CHAIRMAN. On that note, we will stand adjourned.

[Whereupon, at 3:43 p.m., the hearing was adjourned, subject to the call of the Chair.]

NATURAL GAS LEGISLATION

TUESDAY, MARCH 22, 1983

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 10:15 a.m., in room SD-366, Dirksen Office Building, Hon. Pete V. Domenici presiding.

Present: Senators Domenici, Warner, Nickles, Chafee, and Ford.

Also present: Charles A. Trabandt, chief counsel; E. David Doane, deputy chief counsel for energy; Howard Useem, professional staff member; Paul Gilman, professional staff member; and Elizabeth Moler, counsel for the minority.

OPENING STATEMENT OF HON. PETE V. DOMENICI, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator DOMENICI. The hearing will please come to order. This morning we will continue our hearings on natural gas legislation pending before the Energy and Natural Resources Committee.

I might say at the outset as a number of the members of this committee have that we undertake this job understanding that it is an extremely difficult issue. When the Congress passed the Natural Gas Policy Act many thought the problem was solved. Some, if not all, thought that that would be the last legislation needed in the natural gas area. Obviously, it turns out that many of the events could not have been foreseen and that the future wasn't as clear as was thought then.

Likewise we are finding now that those people who produce and buy natural gas could not foresee the future as clearly as they thought. Contract provisions such as take-or-pay clauses and indefinite price escalator clauses were entered into with a thought toward a much different market and a much different time than has actually occurred.

Now we are faced with the task of the best way to correct the problems with the Natural Gas Policy Act. What are those ways? Consumers throughout the United States are asking that we do something. Consumers in New Mexico are certainly among them. They are all concerned about the rising price of natural gas and obviously some changes in the law are going to have to take place, but I would caution my colleagues not to forget the winter of 1976 and 1977 when the paramount issue before our country was supply. Just as in 1979 when we learned that the price of gasoline was not as important as the availability of gasoline, we found that the price of natural gas was not as important as its availability. We must not forget that lesson as we review the legislation today and try and balance the questions of price and supply.

I am pleased that we have a number of witnesses from my State of New Mexico. I would like to open the hearings by asking that Secretary Paul Biderman of the Energy and Minerals Department of the State of New Mexico open, and then we will follow with a panel.

Mr. Secretary, we are delighted to have you. You have prepared remarks that will be made a part of the record. I am going to try to keep the hearing as brief as possible. You use your own good judgment as to whether you want to read the entire statement or summarize it, but nonetheless it will be made a part of the record today. We are glad that you are here and we welcome your testimony.

STATEMENT OF PAUL L. BIDERMAN, SECRETARY, NEW MEXICO DEPARTMENT OF ENERGY AND MINERALS, ACCOMPANIED BY SHEILA HOLLIS, WASHINGTON COUNSEL, NEW MEXICO DEPARTMENT OF ENERGY AND MINERALS

Mr. **Biderman**. Thank you, Senator Domenici. My name is Paul Biderman. I am secretary of the Energy and Minerals Department for the State of New Mexico. I am very pleased to be here, and Senator, I particularly thank you and the Governor, Governor Anaya, thanks you for giving us this extended hearing so that we may present our views today.

Mr. Chairman, I will try to go through my prepared remarks rather quickly and try to avoid some of the technical comments that are in there. Those are in my written statement, and I will not go into those orally, but we are here, I am here to present testimony that hopefully represents a balanced outlook to the whole issue of natural gas supply and natural gas pricing.

My interest in presenting a balanced approach arises from both personal and professional considerations. I am here as an official from a producing State. However, as my biographical sketch indicates, my background has been one of consumer advocacy. In addition, even though New Mexico is a major natural gas producer and our State is dependent on revenues from sales of gas, we are also a consuming State and concerned over the plight of our own gas consumers, and particularly the thousands of low-income households situated in one of the poorest States in the Nation in per capita income.

Mr. Chairman, natural gas pricing is certainly not a foreign subject to us in New Mexico. Our State was very heavily involved in the debate over the Natural Gas Pricing Act of 1978, the NGPA, as you recall, and I personally monitored those developments very intensely as an assistant attorney general in the Consumer Protection Division. We submitted and our office, the attorney general's office, at the time submitted testimony to this committee and others in Congress. We participated in the lengthy and arduous debates and the drafting of amendments to that act, and we have carefully watched the unfolding results of that act and the impacts upon natural gas prices and supplies.

In order to put our views on Senate bill 615 into perspective for you, I have included some written remarks that I am sure, Senator, are quite familiar to you regarding New Mexico's place in the Nation as the fourth largest State both in terms of reserves and production, having some 17.2 trillion cubic feet in reserves, and indeed I would reemphasize that, of course, New Mexico does depend very heavily on natural gas production as one of our major industries and particularly one of our primary sources of employment, tax revenues, and investment opportunities.

Now while our State's natural gas production reaps these economic benefits for us, for many years natural gas has also been the major fuel used by New Mexican residential, commercial, agricultural, and industrial consumers. For many years, other than 1978 and 1979, the contribution of natural gas to the total annual primary energy consumption in the State exceeded that of any other fuel, and even though the contribution of natural gas has overall exhibited a long-term downward trend due in large part to coal's gradual but substantial displacement of natural gas as an input in the generation of electricity, natural gas still accounts for over 35 percent of all primary energy consumed in our State.

This dual status as both a producing and a consuming State puts New Mexico in something of a divided situation. The vast majority of natural gas produced in New Mexico has historically been marketed to out-of-State consumers, yet for over a decade approximately 10 percent of our production has been an essential commodity to intrastate consumers to heat their homes and businesses, to operate their farms and boilers, so we are very concerned about increasing prices for natural gas to our consumers in New Mexico as well as protecting our supplies for our intrastate market.

In addition, our dual link with interstate commerce, both as a producer of natural gas sold to interstate pipelines and as a consumer of gas purchased from interstate companies, helps to define our interest in the Nation's policies concerning natural gas supplies and prices.

What I would like to do is address our overall view of natural gas policy and then turn to the particular perspective of our State toward first NGPA and then Senate bill 615.

Our overall view toward natural gas pricing is something of that of a microcosm of the Nation as a whole. We have in our State government grappled repeatedly with the same dilemmas that continually are faced by Congress—how can this natural gas, this essential commodity, be made available in adequate supply at an affordable price? The law can compel a producer to limit his price, but it cannot compel him to explore or to drill. The law can impose a higher price on certain end users, but it cannot compel them to buy gas at a price which results in a business loss.

New Mexico's administration has concluded that only a free market can bring price and supply into their appropriate balance. The marketplace alone is sufficiently agile to respond to changing demand, increased supplies, or reduced prices for alternative fuels. However skillful the economists, however sophisticated the computer programing, no projection of future supply demand or price can be much better than a guess as evidenced by the disparity of analyses circulating in Congress now, yet every proposal that seeks to regulate price and to do so for years into the future must depend on these projections to replace the free market price.

Set the price too low, supplies will be inadequate. Set the price too high and consumers suffer. Guess right and you avoid curtailments or overcharging, but the market could have spared you the effort and the risk by eliminating those suppliers whose supplies were overpriced and by stimulating new production when demand is up.

We, therefore, Mr. Chairman, do not believe that the continuation of an elaborate system of price controls is in the best interests of consumers or producers. We believe that Senate bill 615 can improve the Nation's situation considerably by providing opportunities for producers to enter the free market while maintaining interim consumer price protection. If certain essential safeguards are included in Senate bill 615, we further believe from the consumer standpoint that no better time exists than the present with competitive oil prices dropping to allow natural gas to seek its market-determined price level.

New Mexico is also motivated by the need to preserve its intrastate gas supply. We did not enjoy a giant industrial base fed by massive numbers of intrastate wells. Only some 10 percent of our total production as I mentioned earlier remains in the intrastate market, yet we want out citizens to enjoy a reliable and reasonably priced supply. If local distribution companies must look to the interstate sources of supply, then our ratepayers may be burdened with superfluous transportation costs charged by the pipelines. Such a situation would present a painful irony to consumers in New Mexico, a State that is abundant in natural gas. With some essential modifications, we feel that Senate bill 615 may give us an opportunity to preserve an intrastate supply adequate for our consumers' needs at a reasonable price.

I shall speak now to the problems that our State confronts under the current pricing law, the NGPA, the Natural Gas Policy Act, and this is really one of the key problems, Mr. Chairman, that New Mexico is facing at this time and one of the key reasons for our support of a concept along the lines of Senate bill 615. We call it the market ordering problem, and it has been identified in prior testimony to this committee.

Since 1978 a number of factors have intervened in the natural gas market situation to begin to threaten the supply and price stability of our Nation's intrastate markets, including New Mexico's.

The NGPA allowed existing supplies of intrastate pipelines to be paid for at the higher price levels of the intrastate market. Old interstate gas continued to be priced on the basis of the pre-NGPA vintaging procedure linked to the first day of first production, thus causing it to draw a considerably lower price than old intrastate gas. By insuring a relatively lower price mix of gas for interstate pipelines, the NGPA has had a tendency to tilt quite drastically the competitive advantage to acquire new gas supplies in favor of interstate pipelines. In contrast to the situation of intrastate pipelines, the lower-priced cushion of old gas available to for the most part interstate pipelines has given these pipelines the advantage of both paying high field prices for the available deregulated or high-cost gas, and maintaining the average cost of gas for their customers at a relatively low level.

This market ordering problem which thus far has mainly caused economic disadvantage of higher prices to New Mexicans will become critical when the NGPA lifts price controls as presently scheduled in January 1985 from most post-April 1977 gas. Because of this partial deregulation program, interstate pipelines will continue to have for a time substantial volumes of low-priced old gas while the gas volumes under the control of those intrastate pipelines will be either deregulated or regulated at considerably higher prices.

Therefore, in New Mexico we will find the typical interstate company's average rolled-in price of all of its system gas supplies to its retail customers to be significantly lower than that of a typical intrastate company. In fact, as partial decontrol occurs, the intrastate company's rolled-in retail price will be much higher and hearer the Btu equivalent price of competitive substitutes such as residual fuel oil which could be burned by its industrial customers having a dual fuel capability.

As a result, of course, the typical intrastate company will have very little leverage to exceed or match an intrastate pipeline's field price offer to acquire new gas supplies, and this in turn may lead to a loss of customers for the intrastate company, beginning with its most price-sensitive industrial customers, and New Mexico's remaining customers will find themselves burdened with added service costs as less industrial customers share the fixed costs of maintaining a distribution system.

In short, the predicament for New Mexico and other producing States, intrastate gas purchases and their customers, may be a most serious one of diminishing ability to purchase adequate gas supplies and paying artificially higher prices for the limited supplies that might be available for purchase. Without any changes to the NGPA as it currently stands, New Mexico's only hope to ease this problem and that really only helps a little is through imposition of its pricing act which I will get to in a few moments.

Another problem that New Mexico faces both as a producer and consumer under the current system of natural gas regulation is the so-called contracts problem. The natural gas markets in the Nation are currently imbalanced. This is reflected in the fact that we still have rising prices despite increases in supply and decreases in demand, and many are attributing this market aberration to the contracts problem between natural gas pipelines and producers. At the time many of these contracts were entered into natural gas markets were confronted with curtailments created by declining supplies, in contrast to our present surplus of gas.

Although various factors are contributing to this rather odd situation, a number of what are now standard provisions contained in natural gas contracts are seen as exacerbating the problem. These include take-or-pay provisions and indefinite price escalator clauses. In particular, take-or-pay obligations entered into by pipelines for their higher-priced production actually appear to be preventing the sale of cheaper New Mexico gas to the detriment of both our own economy and the consumers involved.

To respond to some of these problems, New Mexico in 1977 adopted its own pricing act to limit escalations in old intrastate contracts. Since the passage of the Federal NGPA in 1978, it has become quite apparent that the necessity for this act as a method of maintaining some degree of parity between intrastate and interstate prices has increased. Since the NGPA has, indeed, increased the price differential between old and new gas, New Mexico's NGPA authority to enact its pricing act must remain, in effect, to first insure that sufficient amounts of New Mexico-produced gas remain available for use within the State; second, insure that New Mexico consumers are not placed at a disproportionate disadvantage to out-of-State consumers; and third, to insure that natural gas supplies are high enough to provide for adequate future supplies of gas in the State.

However, should Senate bill 615 in its present form become law and with a few modifications that we will be suggesting as well, the disparity between the two markets would be eliminated and our need for intrastate price controls under those circumstances would no longer exist.

As I hope I have made clear, Mr. Chairman and members of the committee, we, in, New Mexico are not without our own problems not only as a producer of natural gas, but also as a consumer. We believe that the NGPA is exacerbating our problems from both these perspectives and that decontrol would alleviate or remove them.

Barring total deregulation, we support Senate bill 615 with some essential modifications as a method of alleviating our problems considerably. The modifications we seek would effectuate the full, balanced approach that New Mexico is willing to rely upon. I have some suggestions to make in our testimony. I will go through it quickly and avoid some of the technical concerns which are addressed beginning on page 12 and also in an appendix which you should now have received a single page in addition.

We have reviewed, I might add, testimony that has been submitted by other witnesses before this committee as well as discussing this with other people in the State quite extensively.

We first of all feel, Mr. Chairman, that section 603 should be clarified to make sure that it only applies to interstate pipelines in terms of requiring FERC approval for the passthrough of certain gas costs. We do not believe that this bill intends, nor should it, to begin to subject the FERC to—I'm sorry—subject local distribution companies to FERC regulation when they are presently under the control of public service commissions.

Section 202 of the bill, we have a technical concern with the way the language is phrased. It would appear on its face to reestablish NGA nonprice controls on January 1, 1985. We don't think that was intended and suggest reconsideration of that section as described in the testimony.

The most important modification to the bill from New Mexico's standpoint is in title III, and there we would suggest and urge the insertion of a new provision in conjunction with sections 302 and 303 of Senate bill 615 to create a right of first refusal for pipelines and local distribution companies whose producers elect to market out or who elect to terminate their contract as to volumes in excess of the 70-percent take or pay limit. The importance of this provision to us lies in its implications for our intrastate supply system.

Under the legislation as proposed, producers will be able to abrogate their long-term contracts and could elect to do so in large numbers if our intrastate market's pool load factor discourages them. The limited takes required in our intrastate market during the nonheating season mean that production from intrastate wells could remain low. This could happen despite the fact that our intrastate companies have consistently bid higher prices over the years for the State's production. We could in effect lose our years of investment and be forced to purchase from interstate pipelines, thereby incurring superfluous transportation costs. We ask only an opportunity to avoid such an unfair result by allowing pipelines, particularly the intrastate pipelines which is where our concern is, and local distribution companies a right of first refusal of any gas they had previously held under contract, a chance in effect to meet any competing offer.

Such a proposal would do no violence to the contract renegotiation process. The producer could still get his market price, but it could avoid unnecessary disruption to a supply system that consumers depend upon daily and avoid incurring unnecessary transportation charges by pipelines moving gas around more than they need to.

Moreover, should any producers be unsatisfied with market prices that are offered, a right of first refusal could be broad enough to avoid any shutting of wells. We strongly urge the committee to consider such a change.

We also ask under section 163(D), the area of drainage situations, that State jurisdiction be permitted exclusively over the areas where the State now has jurisdiction, and that not be changed to allow FERC to do it as well.

In title IV we do have three modifications there. The first relates to section 401 which amends section 311(A) and (B) of the NGPA. Currently section 311(b) of the NGPA compels intrastate pipelines making sales to interstate pipelines to do so based on the intrastate pipeline's weighted average cost of gas, thus forcing the intrastate pipeline to treat sales made to an interstate pipeline equally for pricing purposes with those made to the intrastate pipeline's intrastate consumers, but Mr. Chairman, Senate bill 615 does not provide the same kind or protection in reverse for the intrastate purchasers, so we would ask that the same privilege be extended both ways. If the intrastate pipeline is going to have to sell to the interstate at its average cost that it services its own customers, the same should be true in reverse.

Second, the proposed amendment to section 312(C) should be clarified to provide that only the State agency and not the FERC may make a surplus natural gas determination with respect to a person over which the State agency has regulatory jurisdiction.

In addition, the definition of surplus natural gas as any natural gas exceeding the then current demands is rather narrow in scope and could be construed to allow a pipeline with a very temporary summer or autumn surplus to assign away rights to receive gas which may be needed during the winter heating season. It should be made clear that the State agency familiar with the needs of the consumers and the supplies of companies it regulates has broader authority to consider any long-term needs and the public interest of the State's citizens rather than mere current demand.

Our third modification and final modification to title IV is in section 403. We ask that there be clarification of subsection (B) regarding consideration for any transportation of gas under the section. Specifically the question is, is the intent to provide that the entire consideration, including the initial cost, not be passed through to customers and rather go in to the stockholders' equity, or should, or pardon me—the stockholders' return, or should only the 5 cent surcharge on top of the cost do that?

We think that is what is intended as appears in the DOE comments. Mr. Chairman, I hope my remarks relating to Senate bill 615 have indicated where the State's main concerns lie, that is, that New Mexico continue to have jurisdiction to assert its regulatory authority as such authority remains if necessary over the intrastate market, and that producing States like New Mexico not be placed in a disadvantageous position with regard to the retention and acquisition of supplies of natural gas for New Mexico consumers.

In this regard, we would like to mention that we would not only like to see intrastate and interstate pipelines placed on an equally competitive footing, but would also like to see local distribution companies and Hinshaw pipelines treated with parity. As I mentioned earlier, Southern Union Co. through its division the Gas Co. of New Mexico supplies three-fourths of our intrastate market and qualifies under NGPA as an Hinshaw pipeline, not an intrastate pipeline, and I would refer you further to our written comments on this point.

Let me add one other thing, Mr. Chairman, that is not in my comments. There is a situation of gravity that has been brought home to us only in the last day or two, and it is a concern that will be brought to your attention by some of the next witnesses.

We share their concern. We do not have a facile solution to the problem, but the concern is that several producers, quite a few producers I should say, independents in the State, have responded to the incentive pricing of the NGPA, having gone into higher-priced production when the NGA effectively asked them to do so through incentive pricing, and they now find themselves in a situation, having sunk considerable investment and considerable loan obligations, they now find themselves in a situation where decontrol could in effect remove the incentive pricing because their contracts could be abrogated. That is a concern that these producers have expressed, Mr. Chairman, and I would ask the committee to consider it.

Senate bill 615 with the modifications we are otherwise suggesting, Mr. Chairman, appears to be the best solution we have seen thus far to problems with our Nation's natural gas markets and prices. It offers a balanced approach to providing a framework for adequate supplies of natural gas to interstate and intrastate consumers at reasonable prices.

As a matter of fact, under the present depressed economic conditions and with oil prices coming down this may just be the perfect time to move ahead with such legislation. In our opinion, with these conditions in existence, prices could conceivably decrease or else increase at a more reasonable rate under deregulation or under the proposed bill, but in any event, the hopeless guessing game of establishing pricing structures suitable to stimulate production for years in advance, that will end.

Mr. Chairman, one other related matter I would like to mention before I close concerning those who represent consuming States, as you know, in many States imported natural gas of extremely higher prices has entered the market. This is yet another constraint on the domestic market and another reason for those high prices consumers are so worried and angered about. In considering deregulation of natural gas prices, I do hope this committee gives some thought to the matter of existing contracts and minimum obligatory takes for high-cost imported natural gas and for minimum take obligations at the pipeline distributor level. In fact, it would be inconsistent with the concept of a freely and efficiently operating market of natural gas for legislation to free contractual constraints on the pipeline producer level and not address those constraints at the pipeline distributor level as well.

Perhaps a FERC investigation of these matters would be the appropriate response.

Mr. Chairman, members of the committee, I thank you again for allowing me to present our perspective on this situation as it exists for us and on this bill.

We commend the committee for its timely hearing of this proposal and offer our assistance in modifying the bill to achieve an equitable approach for producers, pipelines, distributors and all consumers of natural gas.

We do have an appendix that you should have attached to this which addresses several other technical concerns. I would stand ready for any questions, and with me is Sheila Hollis, our Washington counsel for New Mexico, on this subject, and she is also available as a resource.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Biderman follows:]

STATEMENT OF

PAUL L. BIDERMAN, SECRETARY

ENERGY AND MINERALS DEPARTMENT

STATE OF NEW MEXICO

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

MY NAME IS PAUL BIDERMAN AND I AM SECRETARY OF THE ENERGY AND MINERALS DEPARTMENT FOR THE STATE OF NEW MEXICO. IT IS AN HONOR TO BE HERE TODAY BEFORE THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES TO DISCUSS S. 615, THE "NATURAL GAS CONSUMER REGULATORY REFORM AMENDMENTS OF 1983."

GOVERNOR TONEY ANAYA AND I WANT TO EXPRESS OUR APPRECIATION TO THE COMMITTEE FOR ALLOWING US THE OPPORTUNITY TO PRESENT NEW MEXICO'S VIEWS. WE THANK YOU, IN PARTICULAR, MR. CHAIRMAN AND SENATOR DOMENICI, FOR PROVIDING THIS ADDITIONAL DAY OF HEARINGS. WHEN YOU HELD YOUR HEARINGS TWO WEEKS AGO, WE IN NEW MEXICO STATE GOVERNMENT WERE ACTIVELY ENGAGED IN OUR OWN LEGISLATIVE SESSION. OUR LEGISLATURE WAS, ITSELF, ADDRESSING NATURAL GAS PRICES, AND CLEARLY HAS RECOGNIZED THE SIGNIFICANCE OF THE DEBATE OCCURRING HERE AT THE NATIONAL LEVEL.

MR. CHAIRMAN, WE ARE HERE TODAY TO PRESENT TESTIMONY THAT WE HOPE REPRESENTS A BALANCED OUTLOOK TO THE WHOLE ISSUE OF NATURAL GAS SUPPLY AND NATURAL GAS PRICING. MY INTEREST IN PRESENTING A BALANCED APPROACH ARISES FROM BOTH PERSONAL AND PROFESSIONAL CONSIDERATIONS. I AM HERE AS AN OFFICIAL FROM A PRODUCING STATE; HOWEVER, AS MY BIOGRAPHICAL SKETCH INDICATES, MY BACKGROUND HAS BEEN ONE OF CONSUMER ADVOCACY. IN ADDITION, EVEN THOUGH NEW MEXICO IS A MAJOR NATURAL GAS PRODUCER AND OUR STATE IS DEPENDENT ON REVENUES FROM SALES OF

GAS, WE ARE ALSO A CONSUMING STATE CONCERNED OVER THE PLIGHT OF OUR OWN GAS CONSUMERS, PARTICULARLY THE THOUSANDS OF LOW-INCOME HOUSEHOLDS SITUATED IN ONE OF THE POOREST STATES IN THE NATION IN PER CAPITA INCOME.

MR. CHAIRMAN, NATURAL GAS PRICING IS CERTAINLY NOT A FOREIGN SUBJECT TO US IN NEW MEXICO. OUR STATE WAS VERY HEAVILY INVOLVED IN THE DEBATES OVER THE NATURAL GAS PRICING ACT OF 1978 (NGPA), AND I PERSONALLY MONITORED THOSE DEVELOPMENTS VERY INTENSELY AS AN ASSISTANT ATTORNEY GENERAL IN THE CONSUMER PROTECTION DIVISION. WE SUBMITTED TESTIMONY TO THIS COMMITTEE AND OTHERS IN THE CONGRESS. WE PARTICIPATED IN THE LENGTHY AND ARDUOUS DEBATES AND THE DRAFTING OF AMENDMENTS TO THAT ACT. AND WE HAVE CAREFULLY WATCHED THE UNFOLDING RESULTS OF THAT ACT AND ITS IMPACTS UPON NATURAL GAS PRICES AND SUPPLIES.

IN ORDER TO PUT OUR VIEWS ON S. 615 INTO PERSPECTIVE FOR YOU, I WOULD FIRST LIKE TO DISCUSS NEW MEXICO'S ROLE AS A NATURAL GAS PRODUCER AND CONSUMER, AND BRIEFLY ADDRESS OUR OVERALL PHILOSOPHY OF GAS PRICING AND SOME OF THE PROBLEMS WE ARE OR WILL BE EXPERIENCING UNDER THE CURRENT NGPA. I THINK BY GIVING YOU THIS BACKGROUND, YOU WILL BE BETTER ABLE TO UNDERSTAND OUR APPROACH TO S. 615 AND, HOPEFULLY, SEE IT AS AN APPROACH THAT BALANCES THE COMPLEX INTERESTS OF CONSUMERS AND PRODUCERS OF NATURAL GAS.

NEW MEXICO AS A PRODUCER AND CONSUMER OF NATURAL GAS

AT THE END OF 1980 (THE YEAR FOR WHICH THE MOST CURRENT DATA ARE AVAILABLE), TOTAL PROVED RESERVES OF NATURAL GAS IN NEW MEXICO WERE ESTIMATED TO BE 17.2 TRILLION CUBIC FEET. THESE ESTIMATES PLACE NEW MEXICO FOURTH AMONG THE FIFTY STATES IN RESERVES. DURING THE LAST DECADE, NEW MEXICO HAS ALSO BEEN ONE OF THE LARGEST PRODUCERS OF NATURAL GAS IN THE NATION. AND, IN 1981, PRODUCTION OF NATURAL GAS WITHIN OUR STATE REACHED OVER 1.1 TRILLION CUBIC FEET. THIS LEVEL OF PRODUCTION MAINTAINED OUR RANKING AS THE FOURTH LARGEST PRODUCER OF NATURAL GAS IN THE UNITED STATES. WE HAVE COME TO RELY HEAVILY ON NATURAL GAS PRODUCTION AS ONE OF THE MAJOR INDUSTRIES IN OUR STATE, AND ONE OF OUR PRIMARY SOURCES OF EMPLOYMENT, TAX REVENUES, AND INVESTMENT OPPORTUNITY.

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, WHILE OUR STATE'S NATURAL GAS PRODUCTION REAPS THESE ECONOMIC BENEFITS FOR US, FOR MANY YEARS NATURAL GAS HAS ALSO BEEN THE MAJOR FUEL USED BY NEW MEXICO RESIDENTIAL, COMMERCIAL, AGRICULTURAL, AND INDUSTRIAL CONSUMERS. FOR MANY YEARS (EXCEPT 1978 AND 1979), THE CONTRIBUTION OF NATURAL GAS TO THE TOTAL ANNUAL PRIMARY ENERGY CONSUMPTION IN THE STATE EXCEEDED THAT OF ANY OTHER FUEL. AND, EVEN THOUGH THE CONTRIBUTION OF NATURAL GAS HAS, OVERALL, EXHIBITED A

LONG-TERM DOWNWARD TREND - DUE IN LARGE PART TO COAL'S GRADUAL BUT SUBSTANTIAL DISPLACEMENT OF NATURAL GAS AS AN INPUT IN THE GENERATION OF ELECTRICITY - NATURAL GAS STILL ACCOUNTS FOR OVER THIRTY-FIVE PERCENT (35%) OF ALL PRIMARY ENERGY CONSUMED IN THE STATE.

THIS DUAL STATUS AS BOTH A PRODUCING AND A CONSUMING STATE PUTS NEW MEXICO IN A DIVIDED SITUATION. THE VAST MAJORITY OF NATURAL GAS PRODUCED IN NEW MEXICO HAS, HISTORICALLY, BEEN MARKETED TO OUT-OF-STATE CONSUMERS. YET FOR OVER A DECADE, APPROXIMATELY TEN PERCENT (10%) OF OUR PRODUCTION HAS BEEN AN ESSENTIAL COMMODITY TO INTRASTATE CONSUMERS - TO HEAT THEIR HOMES AND BUSINESSES, TO OPERATE THEIR FARMS AND BOILERS. WE ARE THUS VERY CONCERNED ABOUT INCREASING PRICES FOR NATURAL GAS TO NEW MEXICO'S CONSUMERS AS WELL AS THE PROTECTION OF SUPPLIES FOR OUR INTRASTATE MARKET. IN ADDITION, OUR DUAL LINK WITH INTERSTATE COMMERCE - BOTH AS A PRODUCER OF NATURAL GAS SOLD TO INTERSTATE PIPELINES AND AS A CONSUMER OF GAS PURCHASED FROM INTERSTATE COMPANIES (WHICH COMPRISES APPROXIMATELY ONE-THIRD OF THE STATE'S CONSUMPTION) - HELPS TO DEFINE OUR INTEREST IN THE NATION'S POLICIES CONCERNING NATURAL GAS SUPPLIES AND PRICES.

I WILL NOW ADDRESS OUR OVERALL VIEW OF NATURAL GAS POLICY. I WILL THEN TURN TO THE PARTICULAR PERSPECTIVE OF OUR STATE TOWARD FIRST, THE NGPA AND, THEN, S. 615.

NEW MEXICO'S OVERALL VIEW OF NATURAL GAS POLICY

IN FORMULATING OUR OVERALL POLICY TOWARD NATURAL GAS PRICING, NEW MEXICO HAS LONG BEEN IN ONE SENSE A MICROCOSM OF THE NATION AS A WHOLE. WE HAVE, IN OUR STATE GOVERNMENT, GRAPPLED REPEATEDLY WITH THE SAME DILEMMA AS THAT CONTINUALLY FACED BY CONGRESS: HOW CAN AN ESSENTIAL COMMODITY, NATURAL GAS, BE MADE AVAILABLE IN ADEQUATE SUPPLY AT AN AFFORDABLE PRICE? THE LAW CAN COMPEL A PRODUCER TO LIMIT HIS PRICE, BUT IT CANNOT COMPEL HIM TO EXPLORE OR DRILL. THE LAW CAN IMPOSE A HIGHER PRICE ON CERTAIN END-USERS, BUT IT CANNOT COMPEL THEM TO BUY GAS AT A PRICE WHICH RESULTS IN A BUSINESS LOSS.

NEW MEXICO'S ADMINISTRATION HAS CONCLUDED THAT ONLY A FREE MARKET CAN BRING PRICE AND SUPPLY INTO THEIR APPROPRIATE BALANCE. THE MARKETPLACE ALONE IS SUFFICIENTLY AGILE TO RESPOND TO CHANGING DEMAND, INCREASED SUPPLIES, OR REDUCED PRICES FOR ALTERNATIVE FUELS. HOWEVER SKILLFUL THE ECONOMISTS, HOWEVER SOPHISTICATED THE COMPUTER PROGRAMS, NO PROJECTION OF FUTURE SUPPLY, DEMAND, OR PRICE CAN BE MUCH BETTER THAN A GUESS - AS EVIDENCED BY THE DISPARITY OF ANALYSES CIRCULATING IN CONGRESS NOW. YET EVERY PROPOSAL THAT SEEKS TO REGULATE PRICE, AND TO DO SO FOR YEARS INTO THE FUTURE, MUST DEPEND ON THESE PROJECTIONS TO REPLACE THE FREE MARKET PRICE. SET THE PRICE TOO LOW, AND SUPPLY WILL BE INADEQUATE; SET THE PRICE TOO HIGH, AND CONSUMERS WILL SUFFER. GUESS RIGHT, AND YOU

AVOID CURTAILMENTS OR OVERCHARGING, BUT THE MARKET COULD HAVE SPARED YOU THE EFFORT AND THE RISK BY ELIMINATING THOSE SUPPLIERS WHOSE SUPPLIES WERE OVERPRICED AND STIMULATING NEW PRODUCTION WHEN DEMAND IS UP.

WE, THEREFORE, DO NOT BELIEVE THAT THE CONTINUATION OF AN ELABORATE SYSTEM OF PRICE CONTROLS IS IN THE BEST INTERESTS OF CONSUMERS OR PRODUCERS. WE BELIEVE THAT S. 615 CAN IMPROVE THE NATION'S SITUATION CONSIDERABLY BY PROVIDING OPPORTUNITIES FOR PRODUCERS TO ENTER THE FREE MARKET, WHILE MAINTAINING INTERIM CONSUMER PRICE PROTECTION. IF CERTAIN ESSENTIAL SAFEGUARDS ARE INCLUDED IN S. 615, WE FURTHER BELIEVE FROM THE CONSUMER'S STANDPOINT THAT NO BETTER TIME EXISTS THAN THE PRESENT, WITH COMPETITIVE OIL PRICES DROPPING, TO ALLOW NATURAL GAS TO SEEK ITS MARKET DETERMINED PRICE LEVEL.

NEW MEXICO IS ALSO MOTIVATED BY ITS NEED TO PRESERVE ITS INTRASTATE GAS SUPPLY. WE DO NOT ENJOY A GIANT INDUSTRIAL BASE FED BY MASSIVE NUMBERS OF INTRASTATE WELLS; ONLY SOME TEN PERCENT (10%) OF OUR PRODUCTION, AS I MENTIONED EARLIER, REMAINS IN THE INTRASTATE MARKET. YET WE WANT OUR CITIZENS TO ENJOY A RELIABLE AND REASONABLY PRICED SUPPLY. IF LOCAL DISTRIBUTION COMPANIES MUST LOOK TO INTERSTATE SOURCES OF SUPPLY, THEN OUR RATEPAYERS MAY BE BURDENED WITH SUPERFLUOUS TRANSPORTATION COSTS CHARGED BY THE PIPELINES. SUCH A SITUATION WOULD PRESENT A PAINFUL IRONY TO CONSUMERS IN NEW

MEXICO, A STATE ABUNDANT IN NATURAL GAS. WITH SOME ESSENTIAL MODIFICATIONS, WE FEEL THAT S. 615 MAY GIVE US AN OPPORTUNITY TO PRESERVE AN INTRASTATE SUPPLY ADEQUATE FOR OUR CONSUMERS' NEEDS.

I SHALL SPEAK NOW TO THE PROBLEMS THAT OUR STATE CONFRONTS UNDER THE CURRENT PRICING LAW, THE NATURAL GAS POLICY ACT OF 1978 (NGPA).

NEW MEXICO'S PROBLEMS UNDER THE NGPA

THE MARKET ORDERING PROBLEM

SINCE 1978, A NUMBER OF FACTORS HAVE INTERVENED IN THE NATURAL GAS MARKET SITUATION TO BEGIN TO THREATEN THE SUPPLY AND PRICE STABILITY OF OUR NATION'S INTRASTATE MARKETS, INCLUDING NEW MEXICO'S.

THE NGPA ALLOWED EXISTING SUPPLIES OF INTRASTATE PIPELINES TO BE PAID FOR AT THE HIGHER PRICE LEVELS OF THE INTRASTATE MARKET. OLD INTERSTATE GAS CONTINUED TO BE PRICED ON THE BASIS OF THE PRE-NGPA VINTAGING PROCEDURE LINKED TO THE DATE OF FIRST PRODUCTION, THUS CAUSING IT TO DRAW A CONSIDERABLY LOWER PRICE THAN OLD INTRASTATE GAS. BY INSURING A RELATIVELY LOWER PRICED MIX OF GAS FOR INTERSTATE PIPELINES, THE NGPA HAS HAD A TENDENCY TO TILT - QUITE DRASTICALLY - THE COMPETITIVE ADVANTAGE TO ACQUIRE NEW GAS SUPPLIES IN FAVOR OF INTERSTATE PIPELINES. IN CONTRAST TO

THE SITUATION OF INTRASTATE PIPELINES, THE LOWER-PRICED "CUSHION" OF OLD GAS AVAILABLE TO, FOR THE MOST PART, INTERSTATE PIPELINES HAD GIVEN THESE PIPELINES THE ADVANTAGE OF BOTH PAYING HIGH FIELD PRICES FOR THE AVAILABLE DEREGULATED OR HIGH COST GAS AND MAINTAINING THE AVERAGE COST OF GAS FOR THEIR CUSTOMERS AT RELATIVELY LOWER LEVELS.

THIS "MARKET ORDERING PROBLEM," WHICH, THUS FAR, HAS MAINLY CAUSED THE ECONOMIC DISADVANTAGE OF HIGHER PRICES TO NEW MEXICANS, WILL BECOME CRITICAL WHEN THE NGPA LIFTS PRICE CONTROLS IN JANUARY, 1985, FROM MOST POST-APRIL, 1977 GAS. BECAUSE OF THIS PARTIAL DEREGULATION PROGRAM, INTERSTATE PIPELINES WILL CONTINUE TO HAVE, FOR A TIME, SUBSTANTIAL VOLUMES OF LOW-PRICED OLD GAS, WHILE THE GAS VOLUMES UNDER THE CONTROL OF MOST INTRASTATE PIPELINES WILL BE EITHER DEREGULATED OR REGULATED AT CONSIDERABLY HIGHER PRICES. THEREFORE, IN NEW MEXICO, WE WILL FIND THE TYPICAL INTERSTATE COMPANY'S AVERAGE (ROLLED IN) PRICE OF ALL OF ITS SYSTEM GAS SUPPLIES TO ITS RETAIL CUSTOMERS TO BE SIGNIFICANTLY LOWER THAN THAT OF A TYPICAL INTRASTATE COMPANY. IN FACT, AS PARTIAL DECONTROL OCCURS, THE INTRASTATE COMPANY'S ROLLED IN RETAIL PRICE WILL BE MUCH HIGHER AND NEARER THE BTU EQUIVALENT PRICE OF COMPETITIVE SUBSTITUTES (E.G., RESIDUAL FUEL OIL) WHICH COULD BE BURNED BY ITS INDUSTRIAL CUSTOMERS HAVING A DUAL FUEL CAPABILITY. AS A RESULT, OF COURSE, THE TYPICAL

INTRASTATE COMPANY WILL HAVE VERY LITTLE LEVERAGE TO EXCEED OR MATCH AN INTERSTATE PIPELINE'S FIELD PRICE OFFER TO ACQUIRE NEW GAS SUPPLIES. THIS, IN TURN, MAY LEAD TO A LOSS OF CUSTOMERS FOR THE INTRASTATE COMPANY, BEGINNING WITH ITS MOST "PRICE SENSITIVE" INDUSTRIAL CUSTOMERS. AND, NEW MEXICO'S REMAINING CONSUMERS WILL FIND THEMSELVES BURDENED WITH ADDED SERVICE COSTS AS LESS INDUSTRIAL CUSTOMERS SHARE THE FIXED COSTS OF MAINTAINING A DISTRIBUTION SYSTEM.

IN SHORT, THE PREDICAMENT FOR NEW MEXICO AND OTHER PRODUCING STATES' INTRASTATE GAS PURCHASERS AND THEIR CUSTOMERS MAY BE A MOST SERIOUS ONE OF DIMINISHING ABILITY TO PURCHASE ADEQUATE GAS SUPPLIES AND PAYING ARTIFICIALLY HIGHER PRICES FOR THE LIMITED SUPPLIES THAT MIGHT BE AVAILABLE FOR PURCHASE. WITHOUT ANY CHANGES TO THE NGPA, NEW MEXICO'S ONLY HOPE TO EASE THIS PROBLEM - AND IT REALLY ONLY EASES THE PRICING PROBLEM - IS THROUGH IMPOSITION OF ITS PRICING ACT, WHICH I WILL DISCUSS A BIT LATER.

ANOTHER PROBLEM NEW MEXICO FACES BOTH AS A PRODUCER AND CONSUMER UNDER THE CURRENT SYSTEM OF NATURAL GAS REGULATION IS THE SO-CALLED "CONTRACTS PROBLEM." THE NATURAL GAS MARKETS IN THE NATION ARE CURRENTLY IMBALANCED. THIS IS REFLECTED IN THE FACT THAT WE STILL HAVE RISING PRICES DESPITE INCREASES IN SUPPLY AND DECREASES IN DEMAND. AND, MANY ARE ATTRIBUTING THIS MARKET ABERRATION TO THE CONTRACTS PROBLEM BETWEEN NATURAL GAS PIPELINES AND PRODUCERS. AT THE TIME MANY OF THESE CONTRACTS WERE ENTERED INTO, NATURAL GAS MARKETS WERE CONFRONTED WITH CURTAILMENTS CREATED BY DECLINING SUPPLIES, IN CONTRAST TO OUR PRESENT SURPLUS OF GAS.

ALTHOUGH VARIOUS FACTORS ARE CONTRIBUTING TO THIS RATHER ODD SITUATION, A NUMBER OF WHAT ARE NOW STANDARD PROVISIONS CONTAINED IN NATURAL GAS CONTRACTS ARE SEEN AS EXACERBATING THIS PROBLEM. THESE INCLUDE TAKE-OR-PAY PROVISIONS AND INDEFINITE PRICE ESCALATOR CLAUSES. IN PARTICULAR, TAKE-OR-PAY OBLIGATIONS ENTERED INTO BY PIPELINES FOR THEIR HIGHER-PRICED PRODUCTION ACTUALLY APPEAR TO BE PREVENTING THE SALE OF CHEAPER NEW MEXICO GAS, TO THE DETRIMENT OF BOTH OUR OWN ECONOMY AND THE CONSUMERS INVOLVED.

TO RESPOND TO SOME OF THESE PROBLEMS, NEW MEXICO, IN 1977, ADOPTED ITS OWN PRICING ACT TO LIMIT ESCALATIONS IN OLD INTRASTATE CONTRACTS. SINCE THE PASSAGE OF THE NGPA IN 1978, IT HAS BECOME QUITE APPARENT THAT THE NECESSITY FOR THIS ACT AS A METHOD OF MAINTAINING SOME DEGREE OF PARITY BETWEEN INTRASTATE AND INTERSTATE PRICES HAS INCREASED. SINCE THE NGPA HAS, INDEED, INCREASED THE PRICE DIFFERENTIAL BETWEEN OLD AND NEW GAS, NEW MEXICO'S NGPA AUTHORITY TO ENACT ITS

PRICING ACT MUST REMAIN IN EFFECT TO (1) ENSURE THAT SUFFICIENT AMOUNTS OF NEW MEXICO-PRODUCED GAS REMAIN AVAILABLE FOR USE WITHIN THE STATE; (2) ENSURE THAT NEW MEXICO CONSUMERS ARE NOT PLACED AT A DISPROPORTIONATE DISADVANTAGE TO OUT-OF-STATE CONSUMERS; AND (3) ENSURE THAT NATURAL GAS PRICES ARE HIGH ENOUGH TO PROVIDE FOR ADEQUATE FUTURE SUPPLIES OF GAS IN THE STATE. HOWEVER, SHOULD S. 615 IN ITS PRESENT FORM BECOME LAW, THE DISPARITIES BETWEEN THE TWO MARKETS WOULD BE ELIMINATED AND OUR NEED FOR INTRASTATE PRICE CONTROLS WOULD NO LONGER EXIST.

AS I HOPE I HAVE MADE CLEAR, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, WE, IN NEW MEXICO, ARE NOT WITHOUT OUR OWN PROBLEMS NOT ONLY AS A PRODUCER OF NATURAL GAS, BUT ALSO AS CONSUMERS. WE BELIEVE THAT THE NGPA IS EXACERBATING OUR PROBLEMS FROM BOTH THESE PERSPECTIVES, AND THAT DECONTROL WOULD ALLEVIATE OR REMOVE THEM.

BARRING TOTAL DEREGULATION, WE SUPPORT S. 615 WITH SOME ESSENTIAL MODIFICATIONS AS A METHOD OF ALLEVIATING OUR PROBLEMS CONSIDERABLY. THE MODIFICATIONS WE SEEK WOULD EFFECTUATE THE FULL, BALANCED APPROACH THAT NEW MEXICO IS WILLING TO RELY ON. I WOULD NOW LIKE TO MAKE SOME SUGGESTIONS, INTENDED AS CONSTRUCTIVE ONES, FOR THE COMMITTEE'S CONSIDERATION REGARDING S. 615. I WOULD LIKE TO SAY, MR. CHAIRMAN, THAT PRIOR TO MY PREPARING THIS TESTIMONY, WE DISCUSSED

S. 615 WITH OUR REGULATORY BODY, THE NEW MEXICO PUBLIC SERVICE COMMISSION, WITH CONSUMER REPRESENTATIVES, AND WITH INTER- AS WELL AS INTRASTATE PIPELINE COMPANIES AND OUR PRODUCERS. WE ALSO REVIEWED SOME OF THE TESTIMONY SUBMITTED BY OTHER WITNESSES WHO HAVE TESTIFIED ON THIS LEGISLATION. WHILE STATE GOVERNMENT'S POSITION DOES NOT INCLUDE ALL OF INDUSTRY'S AND CONSUMERS' CONCERNS, WE FEEL WE HAVE TAKEN ALL MAJOR CONCERNS FOR THE GOOD OF THE STATE INTO ACCOUNT.

SUGGESTED MODIFICATIONS TO S. 615

TITLE 1 - OUR SUGGESTION FOR MODIFICATION HERE WOULD BE TO CLARIFY, THROUGHOUT, THAT THIS NEW SECTION 603 PERTAINS ONLY TO INTERSTATE PIPELINES. THIS SECTION REFERS TO FERC JURISDICTION AND CONTROL. INTRASTATE PIPELINES, HINSHAW PIPELINES AND DISTRIBUTION COMPANIES ARE REGULATED AT THE STATE LEVEL. WE DO NOT BELIEVE THE ACT INTENDS TO IMPOSE FEDERAL REGULATION ON STATE-REGULATED COMPANIES, NOR DO WE FEEL IT APPROPRIATE THAT THIS BE DONE.

IN THIS REGARD, WE ALSO WISH TO SUGGEST A CLARIFICATION OF THE MEANING OF THE TERM "INTRASTATE PIPELINE". SOUTHERN UNION COMPANY HAS A DIVISION, THE GAS COMPANY OF NEW MEXICO, WHICH SUPPLIES THREE-FOURTHS OF OUR INTRASTATE MARKET AND OWNS AN EXTENSIVE SYSTEM OF GATHERING AND TRANSMISSION LINES

THROUGHOUT THE STATE. SOUTHERN UNION COMPANY IS NOT CLASSIFIED AS AN "INTRASTATE PIPELINE" BUT IS INSTEAD A "HINSHAW PIPELINE" UNDER SECTION 1(C) OF THE NATURAL GAS ACT. IN TITLE III OF THE NGPA, HINSHAW PIPELINES WERE NOT EXPLICITLY ADDRESSED, AND, CONSEQUENTLY, ACTION BY THE FERC WAS NECESSARY TO ENSURE THAT THESE ENTITIES ENJOYED THE SAME ADVANTAGES AS INTRASTATE PIPELINES UNDER SECTIONS 311 AND 312. TO AVOID THIS CONFUSION UNDER THE PRESENT BILL, IT WOULD BE BENEFICIAL TO SPECIFICALLY DEFINE INTRASTATE PIPELINE TO INCLUDE HINSHAW PIPELINES.

TITLE 2 - WE ONLY HAVE ONE MODIFICATION TO PROPOSE IN SECTION 202. IT APPEARS THAT THE INTENT OF THIS SECTION IS TO ELIMINATE NON-PRICE CONTROLS AS OF JANUARY 1, 1985, OR ON THE DATE THAT CONTRACT RENEGOTIATION TAKES PLACE. HOWEVER, WERE THE LANGUAGE CURRENTLY PROVIDED IN THIS SECTION TO SUPERSEDE THAT IN THE NGPA, IT WOULD APPEAR TO STATE THAT SECTION 1B OF THE NATURAL GAS ACT MAY BE REAPPLIED ON JANUARY 1, 1985, TO CERTAIN GAS. THE SECTION COULD BE REWRITTEN TO ELIMINATE THE DECEMBER 31, 1984 EXPIRATION DATE, OR ELSE IT COULD SIMPLY STATE THAT THOSE PROVISIONS OF THE NATURAL GAS ACT WILL NOT APPLY AS OF 1/1/85 OR ON THE DATE RENEGOTIATION TAKES PLACE, WHICHEVER OCCURS FIRST.

TITLE 3 - THE MOST IMPORTANT MODIFICATION TO THE BILL FROM NEW MEXICO'S STANDPOINT WOULD BE TO INSERT A NEW PROVISION IN CONJUNCTION WITH SECTIONS 302 AND 303 OF S. 615 TO CREATE A "RIGHT OF FIRST REFUSAL" FOR PIPELINES AND LOCAL DISTRIBUTION COMPANIES WHOSE PRODUCERS ELECT TO MARKET OUT OR WHO ELECT TO TERMINATE THEIR CONTRACT AS TO VOLUMES IN EXCESS OF THE 70% TAKE-OR-PAY LIMIT. THE IMPORTANCE OF THIS PROVISION TO US LIES IN ITS IMPLICATIONS FOR OUR INTRASTATE SUPPLY SYSTEM.

UNDER THIS LEGISLATION, PRODUCERS WILL BE ABLE TO ABROGATE THEIR LONG-TERM CONTRACTS, AND COULD ELECT TO DO SO IN LARGE NUMBERS IF OUR INTRASTATE MARKET'S POOL LOAD FACTOR DISCOURAGES THEM. THE LIMITED TAKES REQUIRED IN OUR INTRASTATE MARKET DURING THE NON-HEATING SEASON MEAN THAT PRODUCTION FROM INTRASTATE WELLS COULD REMAIN LOW. THIS COULD HAPPEN DESPITE THE FACT THAT OUR INTRASTATE COMPANIES HAVE CONSISTENTLY BID HIGHER PRICES OVER THE YEARS FOR THE STATE'S PRODUCTION; WE COULD, IN EFFECT, LOSE OUR YEARS OF INVESTMENT AND BE FORCED TO PURCHASE FROM INTERSTATE PIPELINES, THEREBY INCURRING SUPERFLUOUS TRANSPORTATION COSTS.

WE ASK ONLY AN OPPORTUNITY TO AVOID SUCH AN UNFAIR RESULT, BY ALLOWING PIPELINES (INTER- OR INTRASTATE) AND LOCAL DISTRIBUTION COMPANIES A RIGHT OF FIRST REFUSAL OF ANY GAS THEY HAVE PREVIOUSLY HELD UNDER CONTRACT; A CHANCE, IN

EFFECT, TO MEET ANY COMPETING OFFER. SUCH A PROPOSAL WOULD DO NO VIOLENCE TO THE CONTRACT RENEGOTIATION PROCESS; THE PRODUCER COULD STILL GET HIS MARKET PRICE. BUT IT COULD AVOID UNNECESSARY DISRUPTION TO A SUPPLY SYSTEM THAT CONSUMERS DEPEND UPON DAILY, AND AVOID INCURRING UNNECESSARY TRANSPORTATION CHARGES BY PIPELINES MOVING GAS AROUND MORE THAN IS NEEDED. MOREOVER, SHOULD ANY PRODUCERS BE UNSATISFIED WITH MARKET PRICES OFFERED, A RIGHT OF FIRST REFUSAL COULD BE BROAD ENOUGH TO AVOID ANY SHUTTING IN OF WELLS. WE STRONGLY URGE THE COMMITTEE TO CONSIDER SUCH A CHANGE.

UNDER TITLE 3, WE ALSO WANT TO POINT OUT A PROBLEM WITH SECTION 316(D), RELATING TO "DRAINAGE SITUATIONS." THIS SHOULD BE A STATE PREROGATIVE, SINCE SUCH MATTERS ARE ALREADY UNDER THE JURISDICTION OF THE NEW MEXICO ENERGY AND MINERALS DEPARTMENT'S OIL CONSERVATION DIVISION, FOR EXAMPLE. LANGUAGE PROVIDED IN SECTION 503(C) OF THE NGPA COULD APPLY HERE - I.E., "ANY FEDERAL OR STATE AGENCY HAVING REGULATORY JURISDICTION WITH RESPECT TO THE PRODUCTION OF NATURAL GAS IS AUTHORIZED TO MAKE DETERMINATIONS REFERRED TO IN THIS SUBSECTION."

TITLE 4 - WE HAVE THREE MODIFICATIONS UNDER TITLE 4 OF THE ACT. THE FIRST RELATES TO SECTION 401 WHICH AMENDS SECTIONS 311(A) AND (B) OF THE NGPA. CURRENTLY, SECTION 311(B) OF THE NGPA COMPELS INTRASTATE PIPELINES MAKING SALES TO INTERSTATE

PIPELINES TO DO SO BASED ON THE INTRASTATE PIPELINE'S WEIGHTED AVERAGE COST OF GAS, THUS FORCING THE INTRASTATE PIPELINE TO TREAT SALES MADE TO AN INTERSTATE PIPELINE EQUALLY FOR PRICING PURPOSES WITH THOSE MADE TO THE INTRASTATE PIPELINE'S INTRASTATE CUSTOMERS. HOWEVER, MR. CHAIRMAN, S. 615 DOES NOT PROVIDE THIS KIND OF PROTECTION IN REVERSE FOR THE INTRASTATE PURCHASER. AS PRESENTLY WRITTEN, S. 615 WOULD PROVIDE THAT SUCH "REVERSE NGPA SECTION 311(B) SALES" BE MADE AT FERC-DETERMINED "JUST AND REASONABLE" RATES AND CHARGES. AS MANY INTRASTATE PIPELINES, LOCAL DISTRIBUTION COMPANIES, AND CONSUMERS HAVE REALIZED, THE FERC'S "OFF-SYSTEM" SALES PROGRAM HAS ALLOWED FOR THE ASSESSMENT OF SIGNIFICANTLY HIGHER RATES TO INTRASTATE CONSUMERS (AS "JUST AND REASONABLE") THAN FOR INTERSTATE CONSUMERS. IF THE INTENT OF S. 615 IS TO PROVIDE PARITY BETWEEN THE MARKETS, THEN THIS SECTION SHOULD PROVIDE EQUAL TREATMENT TO BE ACCORDED TO TRANSACTIONS MADE BETWEEN THE TWO MARKETS. INTRASTATE PIPELINES SHOULD BE INCLUDED IN SECTION 401(B) AND REMOVED FROM THE PROVISIONS OF THE NGPA SECTION 311(B).

SECOND, THE PROPOSED AMENDMENT TO SECTION 312(C) SHOULD BE CLARIFIED TO PROVIDE THAT ONLY THE STATE AGENCY, AND NOT THE FERC, MAY MAKE A "SURPLUS NATURAL GAS" DETERMINATION WITH RESPECT TO A PERSON OVER WHICH THE STATE AGENCY HAS REGULATORY JURISDICTION. MOREOVER, THE DEFINITION OF "SURPLUS

NATURAL GAS" AS ANY NATURAL GAS WHICH EXCEEDS THE "THEN CURRENT DEMANDS" IS FAR TOO NARROW IN SCOPE. THIS COULD POSSIBLY BE CONSTRUED TO ALLOW A PIPELINE WITH A VERY TEMPORARY SUMMER OR AUTUMN SURPLUS TO ASSIGN AWAY RIGHTS TO RECEIVE GAS WHICH MAY BE NEEDED DURING THE WINTER HEATING SEASON. IT SHOULD BE MADE CLEAR THAT THE STATE AGENCY, FAMILIAR WITH THE NEEDS OF ITS CONSUMERS AND THE SUPPLIES OF THE COMPANIES IT REGULATES, HAS BROADER AUTHORITY TO CONSIDER ANY LONGER-TERM NEEDS AND THE PUBLIC INTEREST OF THE STATE'S CITIZENS RATHER THAN MERE "CURRENT" DEMANDS.

OUR THIRD MODIFICATION TO TITLE 4 IS IN SECTION 403, AMENDING TITLE 3 OF THE NGPA TO ADD A NEW SECTION 317. WE WOULD ASK THE COMMITTEE TO CONSIDER CLARIFICATION OF SUB-SECTION (B), PERTAINING TO COSTS FOR CONSIDERATION FOR ANY TRANSPORTATION OF GAS UNDER THIS SECTION. THE LANGUAGE PROVIDED IN THE ACT APPEARS TO CONFLICT WITH THE INTENT OF THE ACT AND WITH THE DESCRIPTION OF WHAT IS INTENDED IN THE DEPARTMENT OF ENERGY'S SUMMARY OF THE ACT. IT IS OUR UNDERSTANDING THAT WHAT IS INTENDED IS THAT THE FIVE CENTS WOULD NOT BE CREDITED AND FLOWED BACK TO THE PIPELINE'S CUSTOMERS, BUT WOULD BE RESERVED FOR THE PIPELINE'S STOCK-HOLDERS. EXCEPT FOR THE SPECIAL TREATMENT OF THE FIVE CENTS, REVENUES UNDER THIS PROVISION WOULD BE TREATED IN THE SAME MANNER AS REVENUE FROM TRANSPORTATION UNDER THE NATURAL

GAS ACT. AS CURRENTLY WRITTEN, IT DOES NOT APPEAR THAT SUBSECTION (B) MAKES THIS POINT CLEAR.

MR. CHAIRMAN, I HOPE MY REMARKS RELATING TO S. 615 HAVE INDICATED WHERE THE STATE'S MAIN CONCERNS LIE - THAT IS, THAT NEW MEXICO CONTINUE TO HAVE JURISDICTION TO ASSERT ITS REGULATORY AUTHORITY, AS NECESSARY, OVER THE INTRASTATE MARKET AND THAT PRODUCING STATES LIKE NEW MEXICO NOT BE PLACED IN A DISADVANTAGEOUS POSITION WITH REGARD TO THE RETENTION AND ACQUISITION OF SUPPLIES OF NATURAL GAS FOR NEW MEXICO CONSUMERS. IN THIS REGARD, WE WOULD LIKE TO MENTION THAT WE WOULD NOT ONLY LIKE TO SEE INTRASTATE AND INTERSTATE PIPELINES PLACED ON AN EQUAL COMPETITIVE FOOTING, BUT WOULD ALSO LIKE TO SEE LOCAL DISTRIBUTION COMPANIES AND HINSHAW PIPELINES TREATED WITH PARITY. AS I MENTIONED PREVIOUSLY, SOUTHERN UNION COMPANY, THROUGH ITS DIVISION, THE GAS COMPANY OF NEW MEXICO, SUPPLIES THREE-FOURTHS OF OUR INTRASTATE MARKET AND QUALIFIES UNDER THE NATURAL GAS ACT AS A HINSHAW PIPELINE RATHER THAN AN INTRASTATE PIPELINE. IF THIS EQUAL FOOTING FOR LOCAL DISTRIBUTION COMPANIES AND HINSHAW PIPELINES IS NOT ESTABLISHED, NEW MEXICO'S INTRASTATE MARKET COULD BE PLACED AT AN EXTREME DISADVANTAGE. THIS TURN OF EVENTS WOULD BE ENTIRELY AT ODDS WITH THE SPIRIT OF S. 615, WHICH SEEKS TO REMOVE ARTIFICIAL MARKET BARRIERS. AND, WITH RESPECT TO THIS CONCERN OF OURS, LET ME EMPHASIZE THAT WE ARE

NOT LOOKING TO PLACE THE INTRASTATE MARKET IN A BETTER COMPETITIVE POSITION; HOWEVER, WE DO FEEL THAT THE INTRASTATE MARKET SHOULD NOT BE PLACED IN AN UNFAVORABLE POSITION AS COMPARED TO THE INTERSTATE MARKET.

S. 615, WITH THE MODIFICATIONS WE ARE SUGGESTING, APPEARS TO BE THE BEST SOLUTION WE HAVE SEEN THUS FAR TO PROBLEMS WITH OUR NATION'S NATURAL GAS MARKETS AND PRICES. IT OFFERS A BALANCED APPROACH TO PROVIDING A FRAMEWORK FOR ADEQUATE SUPPLIES OF NATURAL GAS TO INTERSTATE AND INTRASTATE CONSUMERS AT REASONABLE PRICES. AS A MATTER OF FACT, UNDER THE PRESENT DEPRESSED ECONOMIC CONDITIONS AND WITH OIL PRICES COMING DOWN, THIS MAY JUST BE THE PERFECT TIME TO MOVE AHEAD WITH SUCH LEGISLATION. IN OUR OPINION, WITH THESE CONDITIONS IN EXISTENCE, PRICES COULD CONCEIVABLY DECREASE OR ELSE INCREASE AT A MORE REASONABLE RATE, UNDER DEREGULATION OR UNDER THE PROPOSED BILL. IN ANY EVENT, THE HOPELESS GUESSING GAME OF ESTABLISHING PRICING STRUCTURES SUITABLE TO STIMULATE PRODUCTION FOR YEARS IN ADVANCE WILL END.

MR. CHAIRMAN, THERE IS ONE OTHER SOMEWHAT RELATED MATTER I WOULD LIKE TO MENTION BEFORE I CLOSE MY TESTIMONY. IT ALSO PERTAINS TO THOSE WHO REPRESENT SOLELY CONSUMING STATES. AS YOU KNOW, IN MANY STATES, IMPORTED NATURAL GAS AT EXTREMELY HIGHER PRICES HAS ENTERED THE MARKET. THIS IS YET ANOTHER

CONSTRAINT ON THE DOMESTIC MARKET AND ANOTHER REASON FOR THOSE HIGH PRICES CONSUMERS ARE SO WORRIED AND ANGERED ABOUT. IN CONSIDERING DEREGULATION OF NATURAL GAS PRICES, I DO HOPE THIS COMMITTEE GIVES SOME THOUGHT TO THE MATTER OF EXISTING CONTRACTS AND MINIMUM OBLIGATORY TAKES FOR HIGH-COST IMPORTED NATURAL GAS, AND FOR MINIMUM-TAKE OBLIGATIONS AT THE PIPELINE-DISTRIBUTOR LEVEL. IN FACT, IT WOULD BE INCONSISTENT WITH THE CONCEPT OF A FREELY AND EFFICIENTLY OPERATING MARKET OF NATURAL GAS FOR LEGISLATION TO FREE CONTRACTUAL CONSTRAINTS AT THE PIPELINE-PRODUCER LEVEL AND NOT ADDRESS THOSE CONSTRAINTS AT THE PIPELINE-DISTRIBUTOR LEVEL AS WELL. PERHAPS A FERC INVESTIGATION OF THESE MATTERS WOULD BE IN ORDER.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I THANK YOU AGAIN FOR ALLOWING ME TO PRESENT NEW MEXICO'S PERSPECTIVE ON THE NATURAL GAS SITUATION AS IT EXISTS FOR US AND ON S. 615. WE COMMEND THE COMMITTEE FOR ITS TIMELY HEARING OF THIS PROPOSAL AND OFFER OUR ASSISTANCE IN MODIFYING THE BILL TO ACHIEVE AN EQUITABLE APPROACH FOR PRODUCERS, PIPELINES, DISTRIBUTORS, AND ALL CONSUMERS OF NATURAL GAS. FOR THE RECORD, MR. CHAIRMAN, I AM SUBMITTING AN APPENDIX TO MY STATEMENT WHICH COVERS ADDITIONAL TECHNICAL COMMENTS WE HAVE ON S. 615.

I WOULD BE HAPPY TO AN ANSWER ANY QUESTIONS THE COMMITTEE MAY HAVE FOR ME AT THIS TIME.

THANK YOU.

APPENDIX TO STATEMENT OF PAUL L. BIDERMAN, SECRETARY, ENERGY AND MINERALS DEPARTMENT

TECHNICAL COMMENTS ON S. 615

1. Page 6, Section 201 (a) (line 20)

   The word "amended" needs to be further defined. If not, this section could be interpreted as allowing a contract to avoid the maximum lawful price ceilings merely by introducing a frivolous change to a contract (e.g., change in name, billing procedures, etc.).

2. Page 12, Section 301 (a), "Definition of Gas Cap Price" (lines 9-16)

   This is somewhat confusing; however, the DOE summary does seem to clarify the definition. We would suggest, though, that the words "of the first sale of" be inserted on line 11 after the word "price" and preceeding the word "natural gas." Simply stating "average price" could be interpreted as including the burner tip price of natural gas which we do not believe is the intent of the language.

3. Page 17, Section 303 (a), "Effect of Section 315 Reduction" (lines 14-17)

   This subsection states that the reduction of a take-or-pay obligation pursuant to Section 315 of the NGPA as amended by S. 615 will not be considered an amendment for purposes of marketing out. However, this suggests that reduction of a take-or-pay obligation is sufficent to qualify as an amendment pursuant to other sections of the Act, including Section 201. This matter should be clarified. See comments above on Section 201 (#1).

4. Page 18, Section 303, "Transportation Obligation" (lines 6-24)

   On line 17, after the words "intrastate pipeline," insert "or local distribution company."

5. Page 20, Section 304, "Effect of Gas Cap Price" (line 2 and line 4)

   With respect to the effect of the gas cap price, line 2 talks about "federally imposed price ceilings..." while line 4 refers to a "Federally established rate or price." This language needs to be consistent -- i.e., either federally imposed or federally established, but not both.

Senator **Domenici**. Thank you very much, Secretary Biderman. We will make your technical comments a part of the record and your entire statement.

I want to say at the offset I compliment you for what I consider to be an excellent analysis of the bill, and your suggestions, substantive suggestions seem to have great merit from what I can tell. I have just two or three questions.

It has been said in this committee and I assume you are aware of various positions that Senate bill 615 would place the interstate consumers in a, would place the intrastate consumers in an superior position to the intrastate.

From your testimony I gather that you do not agree with that. In fact, you suggested that there are some changes necessary to make them equal.

Could you give us your version of that assessment by some?

Mr. **Biderman**. Yes, Mr. Chairman. It appears that under the bill as it is presently situated, the intrastate consumer in New Mexico at least, lacking that cushion of old gas that the interstate pipeline usually enjoys, will not be able to increase the bid for the new gas in the field.

Under the present NGPA we are distinctly at a disadvantage to the point that we are concerned about being able to even maintain our intrastate consumption or supply at all after deregulation occurs in 1985 on only new gas, so this cushion that is unavailable to the intrastate markets because of the fact that over so many years we have been bidding on gas at unregulated prices, in effect for the old gas, puts us at a tremendous disadvantage. Senate bill 615 would alleviate that problem and bring us closer to parity, but I mentioned some other things in my testimony that we would still need to even get to an equal position.

Senator **Domenici**. So you certainly don't think that it puts the intrastate at a competitive advantage but to the contrary, it barely gets it up to equal treatment, and without a few changes you are even concerned it won't do that? Is that correct?

Mr. **Biderman**. That is exactly correct, Mr. Chairman.

Senator **Domenici**. While appearing before the committee, Secretary Hodel stated that nothing in this bill, Senate bill 615, would prohibit a State from regulating intrastate markets. You have given us obviously a State's position that we must have our regulatory system left in tact and it must remain effective.

Are you satisfied with the Secretary's interpretation of the legislative language?

Mr. **Biderman**. Well, the way the language reads now it may be somewhat ambiguous because it doesn't really refer to it very directly. Under the NGPA we have a specific opportunity to impose our own regulation which as I recall, Senator, you introduced after discussions in New Mexico. We would like to retain that ability I suppose to allow us the opportunity to respond if in fact that is what is necessitated.

The problem is we don't know how this bill is going to ultimately emerge, and we feel that as it appears now, it would seem that we wouldn't need the authority if the bill comes out the way it is, but it may not end up that way.

Mr. Chairman, Ms. Hollis just pointed out to me as well if you are referring also to things beyond the wellhead regulation and also to the distribution level, we do need the authority there to continue to control the passthroughs and the nonprice aspects as well, that I referred to in my testimony.

Senator DOMENICI. Now you indicated that while there are a lot of problems with the existing law, it did create some incentives for exploration and indeed in New Mexico in the tight sands and the infill drilling we did get quite a major play recently when the demand is so far down that it is causing that to change dramatically.

Are there sufficient incentives in this bill as drawn for continued exploration in your opinion?

Mr. BIDERMAN. Well, I don't think, Mr. Chairman, that the continued exploration is likely to occur for some time in those tight sand areas under this bill, and that is of concern to us and that is why I raised, digressed with your permission from our prepared remarks. It would appear that without the price incentives of the NGPA what we are hearing from our producers is that that simply isn't commercially viable production at this time, as my feeling is, and the reason why we are actually not standing with our producers very dramatically on this issue is that if we look at the long term over the next few years the markets will probably pull that gas out at whatever price it will require, but that may be somewhere down the road, and we are recognizing some real potential detriments to New Mexico, and yet we are also willing to fall back on the free market, and that is what the bill appears to do.

Senator DOMENICI. In other words, the investment may shift for a few years away from that to something else, but over the long haul you are taking the position that it is better for New Mexico to get to the market price as soon as possible and let that other occur? Is that basically the theory?

Mr. BIDERMAN. Yes, Mr. Chairman. I think what we are saying is that ultimately all this will probably come to pass anyway, but the way that it should be done we feel is through getting the market, pulling that gas as appropriate, and for the time being there may indeed be some inequities in the short term.

If the committee can think of any ways of addressing it, we would certainly be supportive.

Senator DOMENICI. Senator Ford?

Senator FORD. Thank you, Mr. Chairman. Let me first compliment you for holding these hearings today. Under the circumstances I hope that you can come forward with your commonsense approach that you did in the earlier consideration of natural gas legislation. I look back on those recommendations and see where we are today and you probably have as good a crystal ball as anybody around.

Mr. Secretary, let me ask you this question. You talked about in various places in your statement surplus gas. Under the present economic condition we know we have a surplus but give me a grassroots guesstimate if you can when you think the so-called surplus or glut will be eliminated and we will be back into the other arena of looking for gas as we did in the economic climate of 1977.

Mr. **Biderman**. Mr. Chairman, Senator Ford, with all due respect, I think that's hopeless. I just don't have the slightest guess. I suppose that what really will determine it is where the oil prices go, and that is just so unpredictable now it is really in the hands of a few people in some ways. That will make a major difference.

Senator **Ford**. You are not in the posture of saying you have any idea when this thing will turn around a little bit, how much surplus you have if you say the bill is a detriment to trying to secure new finds of natural gas? Am I correct that is as you stated it to the chairman a moment ago?

Mr. **Biderman**. What I was referring to was in the area of the tight sands. There is a problem there, yes, but in the area of other kinds of production, no. I think it would actually encourage drawing supply.

Senator **Ford**. Senator Domenici will tell you that one of our problems in the Natural Gas Policy Act was trying to find some way to secure the gas from intrastate markets into the interstate markets. We were finding hundreds of thousands of people being unemployed because of the shortage and several States, the producing States, had no problem with the use of natural gas, and we hopefully were able to turn that around. I think we did for a while.

You are concerned about old gas in the intrastate market. One thing I want to bring to your attention here is it appears to this Senator that this legislation will create another dual market. That dual market is substantiated I think by the fact that the interstate will have a cap and the intrastates will not. All an intrastate would have to do would be bid a factor or two more than the cap of the competing interstate and the so-called gas then beyond the cap would go to the intrastate and not to the interstate.

Mr. **Biderman**. Well, Mr. Chairman, Senator Ford, that is one aspect of the bill, but it is not the total picture.

Senator **Ford**. But we still will have a dual system and Mike Butler stated in his testimony that between January 1, 1985, and January 1, 1986, we could develop a very hard-line, two-tier system, intra and inter.

Mr. **Biderman**. Well, Mr. Chairman, Senator, I think again it is hard to predict what is going to happen, and obviously that is what we are trying to do.

Senator **Ford**. The prediction here is I think drawn out in the legislation pretty clear as substantiated by the chairman of FERC.

Mr. **Biderman**. I understand, Mr. Chairman. What I am trying to bring out is that in the case of New Mexico, we export 90 percent of our production already, and for us to bear the cost of any other State that perhaps is developing its reserves for intrastate production seems like it catches us right in a vice.

We are not using our production to the point that we are making a 50-percent or 70-percent intramarket into processing facilities and feedstock use and all that. We are barely trying to hold on to what we have got.

Senator **Ford**. How much old gas do you deliver? Mr. Chairman, if I take too long, stop me.

Senator **Domenici**. That's fine.

Senator **Ford**. How much old gas? And we are on intrastate consuming States, and I have heard this in Louisiana, a producing

State, it has to consume its own production or it will go around loop-de-loop and come back in the interstate pipeline.

How much old gas do you consume in New Mexico in intrastate?

Mr. Biderman. Mr. Chairman, I believe that about half our gas is classified as old in one way or another. That would include some gas that is under the intrastate system as well which is not priced at old gas prices.

Senator Ford. So 50 percent of your consumption is about ready to be deregulated?

Mr. Biderman. Mr. Chairman, I think that is correct.

Senator Ford. The old gas will be deregulated under this.

Senator Domenici. But it wasn't regulated before because we were intrastate.

Senator Ford. But we are going to deregulate old gas, aren't we, under this legislation? OK. Won't that raise the price? Don't you limit the price in producing States the same as you do consuming States?

Mr. Biderman. Mr. Chairman, we do have a limit, but the limit is much higher than the limit that is presently imposed on the interstate prices. We have a limit that right now is about $1.80 an mcf on old gas in the intrastate market.

Senator Domenici. About 33 percent higher under our regulatory, State regulatory scheme than the old fixed price for old gas that is shown in the interstate; is that correct, Mr. Secretary?

Mr. Biderman. Mr. Chairman, I believe it is about 37 percent.

Senator Ford. I'm lost, Pete. I thought we had a price on old gas, a cap on old gas, and you allow more for old gas than the Federal cap.

Mr. Biderman. Mr. Chairman, Senator, we did not have any price controls at all until 1977, and at that time because of the growing disparity between the controls on the interstate old gas and the decontrolled old gas that the intrastate market was using, we were facing such a great disparity that the legislation, you imposed a price control on old gas intrastate, but that cap or that ceiling at that time was placed at essentially the new gas price, the 102 price. That is not exactly there now, but it is still at about $1.80. It's a good deal higher than the old gas caps in the interstate markets. We are carrying a great deal heavier burden.

Senator Domenici. What we are saying is in New Mexico, Senator, the intrastate, while it is not the entire user market in the State, we have some interstate supplies but that portion which is intra we don't have the old gas price which is capped under the Natural Gas Policy Act because in the intrastate market there was no regulation when we passed the NGPA, but New Mexico in 1977 passed their own which we permitted and we made very clear in the Natural Gas Policy Act, and it has never been at that low price. I think that is what the Secretary is saying.

In fact, it is almost a new price gas, at the price of new gas under the NGPA, but for the growth that has occurred which New Mexico hasn't permitted the growth in price, hasn't permitted in all respects under their statute.

Senator Ford. This is going to be the exception that proves the rule I think where other States have the cap that was imposed by the NGPA. I see your attorney smiling a little bit. I know where she used to work, and if you want to tell me I'm wrong, I am always delighted to be admonished by a competent woman.

Senator DOMENICI. In this case, one that certainly knows what she is talking about.

Senator FORD. I understand.

Ms. HOLLIS. Well, with your permission to go ahead and explain my understanding of it——

Senator FORD. I want it.

Senator DOMENICI. We already know who is speaking, so you can proceed.

Ms. HOLLIS. The Kansas and Oklahoma statute sets prices for their old gas in a way that basically controls the operation, and they have price escalators at I believe a significantly lower level than the level that is set in the New Mexico Natural Gas Pricing Act.

The New Mexico Gas Pricing Act was passed in 1977 in response to problems under opinion 77 and 77A on the operation of indefinite price escalators which was driving the price of gas up in New Mexico at an extremely fast rate.

In New Mexico right now there is not only consumption of intrastate gas but interstate supplies as well of a significant degree. If S. 615 in its approximately present form, same program for deregulation, occurs, then of course that natural gas price, the interstate gas will be deregulated. The New Mexico Gas Pricing Act the Secretary has stated would no longer have the same degree of relevance as it did under the old Natural Gas Act pricing structure or even the NGPA pricing structure, and where the exact price level would come out is something that is still being calculated in the State because of the mix of gas in the State.

It is a very interesting situation where it is about 50-50 104 gas, 50 percent other categories of gas and where what the mix will be and where the average price would come out is not clear yet.

Senator FORD. Well, if you are not clear, then how can we determine where you will come out as it relates to the bidding on old gas compared to the problems that the interstates will have?

Mr. BIDERMAN. Well, one happens——

Senator FORD. The old interstate gas that you will be able to bid on.

Mr. BIDERMAN. I'm sorry?

Senator FORD. Old interstate gas that you will be able to bid on.

Mr. BIDERMAN. Mr. Chairman, we don't know, but we figure that the market will decide where we will end up, and that is really our point.

Senator FORD. Are you saying you want to keep price controls on your own intrastate gas?

Mr. BIDERMAN. Mr. Chairman, no; our only point there was that we don't know exactly how this bill is going to emerge. If there is a free market, we don't expect we are going to need any kind of controls, but there are so many possible quirks or kinks that we don't know exactly how it is going to end up and we would like to have the discretion to possibly continue controls in New Mexico if it avoids some kind of disparity, particularly if old gas continues to be capped or somehow controlled other than through 615. If it continues to be controlled at the Federal level, we have to have that authority.

Senator FORD. Well, New Mexico has its own pricing control then.

Mr. BIDERMAN. Yes, Mr. Chairman.

Senator FORD. That is for intrastate production?

Mr. BIDERMAN. Pre-1975 intrastate production.

Senator FORD. If we move to a free market as you advocate in your statement, how could you justify continuation of an intrastate price control?

Mr. BIDERMAN. I wouldn't, Mr. Chairman. If we definitely moved to a free market, I don't.

Senator FORD. How do you substantiate the price for old gas that is going to accelerate beyond anything reasonble now and putting a cap on interstate as this bill does. Then you have the ability on the intrastate to bid just one smidgeon more than the old gas on the interstate when you limit the interstate?

Mr. BIDERMAN. Mr. Chairman, Senator, we feel that if there is decontrol, that this would work itself out probably a lot better than under any form of control we could impose. It would work itself out, but not immediately. It would take a few years probably.

Senator FORD. What I am getting at, and I don't want to get in the posture of badgering you and I apologize if you think I am. What we have, it may not be a problem to New Mexico, but I think we have the problem in other States. I think we are on the verge of going to a dual system again which we endeavored to get out of in 1977, and that is what has me bothered.

Let me ask you when you advocate a free market--I guess I just have two questions, Mr. Chairman, and then I will quit. You advocate a free market for natural gas. Do you mean a free market at all levels—production, interstate transmissions, distribution?

Mr. BIDERMAN. Well, Mr. Chairman, that wasn't part of my testimony. At this point I am only addressing the production. I certainly would be open to consideration of other levels as well.

Senator FORD. Are you familiar with the bill's cap and control on distribution and control on the pipelines but no control on the production?

Mr. BIDERMAN. You are referring to section 603, Senator?

Senator FORD. I believe that's right.

Mr. BIDERMAN. Yes. I have read that.

Senator FORD. So there is no control on production under this piece of legislation, but there is control over transmission lines. There is also control over distribution systems, by public service commissions, however you went to call them. They will have jurisdiction over distribution systems and FERC over transmission lines, but nothing on the production. You want S. 615 to apply only to interstate pipelines?

Mr. BIDERMAN. I haven't said that, Senator. You are referring to the whole bill?

Senator FORD. Yes, just 615.

Mr. BIDERMAN. No. We accept that for intrastate and interstate markets.

Senator FORD. What about the cap? Passthrough—I'm sorry; the cap on the passthrough?

Mr. **Biderman**. On that, Senator, I think we had accepted the bill as it was written. We would have to analyze the effects of a cap being imposed on intrastate. We hadn't considered that because it wasn't in there. We would be more receptive to a passthrough control exercised by States over the local distribution companies by the State public service commission rather than by the FERC because we don't want to see FERC start to control State companies.

Senator **Ford**. Well, we are looking at a free market with controls, and I don't think you can arrive at a free market with controls.

Mr. **Biderman**. Senator——

Senator **Ford**. At least it is difficult for me to see where you are going to put caps on this and regulate this and you just say as long as the State has the control over distribution systems and control over intrastate pipelines—then we get into the problem we tried to get out of before. I thought we did a reasonable job of getting out of it and giving incentive for—and I learned infill drilling from Senator Domenici. He explained it to me pretty good. The country boy understood it—just put more straws in the soda, and I understood that. I understood that very well, and I learned a lot and I still remember. That is 5 years ago he taught me that.

Senator **Domenici**. So long as it is consistent with good conservation practices.

Senator **Ford**. I don't remember that caveat then. Mr. Chairman, you're delightful. The Secretary has been a good witness, and I compliment him.

Senator **Domenici**. Let me just say, Senator Ford, I think the thrust of the Secretary's remarks with reference to 1985 coming along and we have deregulation but for old gas, I think the thrust of his statement is a State like ours is not going to get any of the old gas. I guess that is really what he is saying. If it is going to really go elsewhere, we are worried about it going back into our State.

Under this bill, the position as I understand the underlying premise is that huge amounts of old gas that will still be regulated, we are obviously not going to get a shot at much of that under the present situation, and you seek some equity in that respect even under this bill.

Senator **Ford**. You find many in industries as I understand it that are now using natural gas on intrastate lines. It is old gas and it is low priced. If you deregulate old gas and allow it to go seek its level, then you have in my opinion cast the death spell on consumers and communities and et cetera as it relates to some intrastate markets.

That is what I am trying to get to, and I think it is in there and I think it is in this piece of legislation and I think some people are beginning to realize it is there.

I thank you.

Senator **Domenici**. Thank you very much, Mr. Secretary. I am delighted to have you and we will be in contact with you as we proceed through markup one of these weeks. Thank you very much.

Our next panel consists of A. M. Derrick, senior vice president of El Paso Natural Gas, El Paso, Tex; Michael Lambert, vice president of Gas Supply, Gas Co. of New Mexico, Dallas, Tex., George

Yates, vice president of New Mexico Independent Petroleum Association.

Would you please take the witness seat? We will start with Mr. Derrick, El Paso Natural Gas, then we will take Mr. Lambert, and then we will take Mr. Yates.

Would you reflect in the record, please, that George Yates is accompanied by Mr. Albert Greer, Farmington, N. Mex.

STATEMENT OF A. M. DERRICK, SENIOR VICE PRESIDENT, EL PASO NATURAL GAS CO.

Mr. **Derrick**. Thank you, Mr. Chairman. I am A. M. Derrick, senior vice president, the El Paso Natural Gas Co.

El Paso appreciates the opportunity to appear here this morning as both an interstate pipeline and a producer. We will offer our comments on the natural gas legislation pending before this committee.

El Paso has owned and operated interstate gas pipeline systems since 1929. Today that system extends across the southwestern United States from western Oklahoma and Texas to the California border.

In 1982 El Paso sold slightly more than 1 trillion cubic feet of gas from its system. Eighty-two percent of this gas went to two California distribution companies, 13 percent to distributors for resale in Texas, New Mexico, Arizona, Utah, Nevada, Colorado, Oklahoma, and 5 percent went to industrial customers for direct use in Texas, New Mexico, and Arizona.

El Paso purchases from independent producers most of the natural gas it sells. Approximately 3 percent of its supplies are bought from affiliated companies. El Paso also has long been a producer of natural gas principally from pipeline company-owned leases in the San Juan Basin area of northwest New Mexico and southwest Colorado.

Pipeline production represents about 18 percent or 680 million cubic feet per day of El Paso's current available supply. Initially I would like to comment briefly on the need for legislation.

El Paso supported passage of the Natural Gas Policy Act of 1978. In many important respects, the NGPA has worked well. Its wellhead price incentives have renewed the search for natural gas in the United States and for the first time made economically feasible exploration of the ultradeep horizons of the Anadarko Basin. Extension of wellhead price controls to intrastate sales restored interstate pipelines to competitive parity with intrastate pipelines and soon enough new supplies were moving to the interstate markets to end curtailments of service and to permit local regulators to end moratoriums on new distributor connections.

The NGPA enabled intrastate pipelines for the first time to voluntarily transport gas for interstate pipelines and distributors without subjecting them to Federal regulation or risking loss of their intrastate supplies.

El Paso and other interstate buyers were thus able to expand their search for gas beyond the physical reach of their own pipeline system. In each of the 6 years prior to passage of the NGPA, El Paso was able to replace only about 25 percent of the gas which it sold each year. Since 1978, El Paso has acquired about as much gas as it has sold.

Events of the past year in El Paso's marketplace, however, have convinced us, Mr. Chairman, that new legislation is needed. These events indicate that the regulated gas industry is not well equipped today to fully and quickly respond to competition at the burner tip. Rigidities exist between the wellhead and the burner tip which prevent prompt responses to competition. Some of these rigidities are physical facts—the relative immobility of a pipeline or distribution system once constructed, the location of gas supplies in the United States. Others are more transitory, and today are largely creatures of the regulatory environment—the terms of purchase at the wellhead, the conditions of sale at the burner tip—yet these contractual arrangements once agreed to and relied upon become very difficult to alter by mutual agreement and virtually impossible to alter unilaterally by private initiative.

Still another rigidity is the regulatory environment itself. The NGPA price ramp which drives wellhead prices upward even while the demand for gas falls is a prime example. El Paso applauds the administration for taking the initiative to legislatively address these problems in the natural gas industry. These problems are pervasive. The solutions must be comprehensive.

The Hodel bill represents sensible and thoughtful legislation which we believe with the following three modifications can help the natural gas industry to transform itself to compete at the burner tip with unregulated forms of energy.

The first modification, effective legislation must address minimum bills in contracts between pipelines and distributors.

El Paso's situation is illustrative of this market barrier. Since 1978, working within the framework of the NGPA, El Paso has managed its gas acquisition from transmission costs such that today it can offer the lowest cost, out-of-state supply to the California market.

However, its distributor companies in that State are unable to purchase El Paso's gas ahead of higher cost supplies. They are prevented from buying the lowest cost gas first because of minimum purchase contracts with other interstate pipelines. As a consequence, since April of 1982, sales of El Paso's gas in California have varied within a 24-hour period by nearly a billion cubic feet. The takes from El Paso depend on the market demand remaining after the distributors have taken their required minimum purchases of higher cost gas. On many days El Paso gas at approximately $3.73 per million Btu has been left unpurchased in the pipeline in favor of Canadian supplies arriving at the California border at prices ranging from $5 to $8 a million Btu. El Paso's 1982 sales declined by 650 million cubic feet of gas a day. In 1982 these rigidities in pipeline distributor contracts have cost California customers more than $250 million in avoidable gas costs.

High pipeline distributor minimum bills may be justified in the particular circumstances of a given system. Legislation which arbitrarily nullifies all such provisions may harm rather than help the public interest. Nevertheless, effective legislation must address rigidities at the market end of the pipeline.

The second modification we would suggest is that the Hodel bill's approach to pipeline accountability must be modified. As now proposed, it penalizes interstate pipelines which have managed their supplies to minimize gas costs.

Since the allowed rate is the average price per million Btu's that a pipeline paid for gas delivered to it during the month preceding enactment, those pipelines who have managed their supply to minimize costs are disadvantages relative to those pipelines with higher costs. This is because the higher costs pipelines will have a greater pool of dollars which will be allowed passthrough. Our studies show that of the 19 major interstate pipelines, El Paso's gas costs are in the lowest one-fourth of such pipelines.

Further, interstate pipelines will be severely disadvantaged in the competition for new gas supplies relative to intrastate pipelines and other new buyers who have no such pipeline accountability applicable to them. This poses the specter of the re-creation with a vengance of all of the dual-market distortions which the NGPA was enacted to eliminate in 1978.

Moreover, with the pipeline transportation provisions, intrastate pipelines, distributors, and industrial users will now be bidding for gas supplies at the wellhead. Interstate pipelines, burdened with the risks created by the passthrough limitation provisions, will find it difficult to secure adequate supplies to serve their remaining system customers. Interstate pipelines must not be disadvantageous in their efforts to supply customers who cannot obtain their own supply.

One way to reach a better competitive balance between wellhead bidders while still holding interstate pipelines to a higher degree of accountability would be to limit guaranteed passthrough only to gas purchase costs which do not exceed the gas cap. El Paso supports the two modifications to the passthrough provision suggested by FERC Chairman Butler in his testimony before this committee on March 12, 1983, namely, that the Commission be empowered to approve rates based on reasonable projections of future gas costs and pipelines be allowed to recover in one way or another legitimate purchased gas costs incurred before the Commission's final decision.

The third and last modification that we would suggest is that natural gas owned and produced by pipelines should be granted parity treatment at the wellhead with gas produced by others.

Natural gas produced and owned by pipeline companies is a small but important part of the Nation's domestic gas supplies. According to one Department of Energy report, pipeline production constituted approximately 3 percent of the Nation's total production in the 1979-81 period. For comparison, 1982 gas imports from Canada comprised approximately 4 percent of the gas consumed in the United States.

On individual pipeline systems the significance of pipeline-produced gas may be much greater. As I stated at the outset, pipeline-produced gas represents 18 percent or 679 million cubic feet per day of the natural gas projected to be available to El Paso's system during 1983.

The failure of Congress in 1978 to explicitly include pipeline-produced gas within the NGPA's first sale definition has produced debate regarding whether Congress intended in 1978 to apply the NGPA's provisions to all gas produced within the United States, including pipeline production. That question is now before the United States Supreme Court in the *Mid-Louisiana* case. If this Congress determines to establish a natural gas wellhead pricing and price-decontrol policy to comprehensively address all present and future natural gas produced in the United States, pipeline production should be governed at the wellhead by the legislation applicable to all other domestic gas production. Legislative language to accomplish this is appended to my written statement.

Inclusion by this Congress of pipeline-produced gas into the legislative framework provided for all other domestic natural gas will not affect the Supreme Court's resolution of what Congress intended in 1978. By expressly including pipeline production as a first sale, Congress would not be granting pipeline companies a blank check in pricing their own pipeline production at the wellhead for ratemaking purposes. In order for the wellhead price assigned by a pipeline to its own production to be flowed through in its rates, the price would have to satisfy several tests.

First, the pipeline must demonstrate to the FERC's satisfaction that it has not agreed to price the pipeline-produced gas at a different price.

Second, if the gas production is subject to price controls, the price cannot exceed the relevant NGPA maximum lawful price.

Third, the pipeline price assigned could not exceed the price agreed to in comparable sales between nonaffiliated sellers and buyers in arms-length transactions.

And finally, the wellhead price assigned to pipeline production must be sensitive to market signals. The pipeline must carefully consider whether the wellhead price assigned to its own pipeline production when added to the other gas costs and its transmission costs will allow its product to be sold in the marketplace.

Thank you, Mr. Chairman. That concludes my statement. I would be happy to try to answer your questions.

[The prepared statement of Mr. Derrick follows:]

Statement of

A. M. DERRICK

Senior Vice President, El Paso Natural Gas Company

THANK YOU MR. CHAIRMAN.

I AM A. M. DERRICK, SENIOR VICE PRESIDENT OF EL PASO NATURAL GAS COMPANY.

EL PASO APPRECIATES THE OPPORTUNITY TO APPEAR HERE THIS MORNING AS BOTH AN INTERSTATE PIPELINE AND A PRODUCER TO OFFER OUR COMMENTS ON THE NATURAL GAS LEGISLATION PENDING BEFORE THIS COMMITTEE.

EL PASO HAS OWNED AND OPERATED AN INTERSTATE GAS PIPELINE SYSTEM SINCE 1929. TODAY THAT SYSTEM EXTENDS ACROSS THE SOUTHWESTERN UNITED STATES FROM WESTERN OKLAHOMA AND TEXAS TO THE CALIFORNIA BORDER.

IN 1982, EL PASO SOLD SLIGHTLY MORE THAN ONE TRILLION CUBIC FEET OF GAS FROM ITS SYSTEM: EIGHTY-TWO PERCENT [837 BCF] TO TWO CALIFORNIA DISTRIBUTION COMPANIES; THIRTEEN PERCENT [132 BCF] TO DISTRIBUTORS FOR RESALE IN TEXAS, NEW MEXICO, ARIZONA, NEVADA, UTAH, COLORADO, AND OKLAHOMA; AND FIVE PERCENT [50 BCF] TO INDUSTRIAL CUSTOMERS FOR DIRECT USE IN TEXAS, NEW MEXICO, AND ARIZONA.

EL PASO PURCHASES FROM INDEPENDENT PRODUCERS MOST OF THE NATURAL GAS IT SELLS. APPROXIMATELY THREE PERCENT OF ITS SUPPLIES ARE BOUGHT FROM AFFILIATED PRODUCERS.

EL PASO HAS ALSO LONG BEEN A PRODUCER OF NATURAL GAS, PRINCIPALLY FROM PIPELINE COMPANY-OWNED LEASES IN THE SAN JUAN BASIN AREA OF NORTHWEST NEW MEXICO AND SOUTHWEST COLORADO. PIPELINE PRODUCTION REPRESENTS ABOUT EIGHTEEN PERCENT [680 MMCF/D] OF EL PASO'S CURRENTLY AVAILABLE SUPPLY.

INITIALLY I'D LIKE TO COMMENT BRIEFLY ON THE NEED FOR LEGISLATION:

EL PASO SUPPORTED PASSAGE OF THE NATURAL GAS POLICY ACT OF 1978. IN MANY IMPORTANT RESPECTS, THE NGPA HAS WORKED WELL. ITS WELLHEAD PRICE INCENTIVES HAVE RENEWED THE SEARCH FOR NATURAL GAS IN THE UNITED STATES AND FOR THE FIRST TIME MADE ECONOMICALLY FEASIBLE EXPLORATION OF THE ULTRA DEEP HORIZONS OF THE ANADARKO BASIN.

EXTENSION OF WELLHEAD PRICE CONTROLS TO INTRASTATE SALES RESTORED INTERSTATE PIPELINES TO COMPETITIVE PARITY WITH INTRASTATE PIPELINES AND SOON ENOUGH NEW SUPPLIES WERE MOVING TO THE INTERSTATE MARKETS TO END CURTAILMENTS OF SERVICE AND TO PERMIT LOCAL REGULATORS TO END MORATORIUMS ON NEW DISTRIBUTOR CONNECTIONS.

THE NGPA ENABLED INTRASTATE PIPELINES FOR THE FIRST TIME TO VOLUNTARILY TRANSPORT GAS FOR INTERSTATE PIPELINES AND DISTRIBUTORS WITHOUT SUBJECTING THEMSELVES TO FEDERAL REGULATION OR RISKING LOSS OF THEIR INTRASTATE SUPPLIES. EL PASO AND OTHER INTERSTATE BUYERS WERE THUS ABLE TO EXPAND THEIR SEARCH FOR GAS BEYOND THE PHYSICAL REACH OF THEIR OWN PIPELINE SYSTEMS.

IN EACH OF THE SIX YEARS PRIOR TO PASSAGE OF THE NGPA, EL PASO WAS ABLE TO REPLACE ONLY ABOUT TWENTY-FIVE PERCENT OF THE GAS WHICH IT SOLD. SINCE 1978, EL PASO HAS ACQUIRED ABOUT AS MUCH NEW GAS EACH YEAR AS IT HAS SOLD.

EVENTS OF THE PAST YEAR IN EL PASO'S MARKETPLACE, HOWEVER, HAVE CONVINCED US, MR. CHAIRMAN, THAT NEW LEGISLATION IS NEEDED. THESE EVENTS INDICATE THAT THE REGULATED GAS INDUSTRY IS NOT WELL EQUIPPED TODAY TO FULLY AND QUICKLY RESPOND TO COMPETITION AT THE BURNERTIP.

RIGIDITIES EXIST BETWEEN THE WELLHEAD AND THE BURNERTIP WHICH PREVENT PROMPT RESPONSES TO COMPETITION.

SOME OF THESE RIGIDITIES ARE PHYSICAL FACTS--THE RELATIVE IMMOBILITY OF A PIPELINE OR DISTRIBUTION SYSTEM ONCE CONSTRUCTED; THE LOCATION OF GAS SUPPLIES IN THE UNITED STATES.

OTHERS ARE MORE TRANSITORY AND TODAY ARE LARGELY CREATURES OF THE REGULATORY ENVIRONMENT--THE TERMS OF PURCHASE AT THE WELLHEAD, THE CONDITIONS OF SALE AT THE BURNERTIP. YET THESE CONTRACTUAL ARRANGEMENTS, ONCE AGREED TO AND RELIED UPON, BECOME VERY DIFFICULT TO ALTER BY MUTUAL AGREEMENT AND VIRTUALLY IMPOSSIBLE TO ALTER UNILATERALLY BY PRIVATE INITIATIVE.

STILL ANOTHER RIGIDITY IS THE REGULATORY ENVIRONMENT ITSELF: THE NGPA PRICE RAMP WHICH DRIVES WELLHEAD PRICES UPWARD EVEN WHILE THE DEMAND FOR GAS FALLS IS A PRIME EXAMPLE.

EL PASO APPLAUDS THE ADMINISTRATION FOR TAKING THE INITIATIVE TO LEGISLATIVELY ADDRESS THESE PROBLEMS IN THE NATURAL GAS INDUSTRY. THESE PROBLEMS ARE PERVASIVE. THE SOLUTION MUST BE COMPREHENSIVE.

THE HODEL BILL REPRESENTS SENSIBLE AND THOUGHTFUL LEGISLATION WHICH WE BELIEVE, WITH THE FOLLOWING THREE MODIFICATIONS, CAN HELP THE NATURAL GAS INDUSTRY TO TRANSFORM ITSELF TO COMPETE AT THE BURNERTIP WITH UNREGULATED FORMS OF ENERGY.

FIRST, EFFECTIVE LEGISLATION MUST ADDRESS MINIMUM BILLS IN CONTRACTS BETWEEN PIPELINES AND DISTRIBUTORS.

EL PASO'S SITUATION IS ILLUSTRATIVE OF THIS MARKET BARRIER. SINCE 1978, WORKING WITHIN THE FRAMEWORK OF THE NGPA, EL PASO HAS MANAGED ITS GAS AQUISITIONS AND TRANSMISSION COSTS SUCH THAT, TODAY, IT CAN OFFER THE LOWEST COST OUT OF STATE SUPPLY TO THE CALIFORNIA MARKET. HOWEVER, ITS DISTRIBUTOR CUSTOMERS IN THAT STATE ARE UNABLE TO PURCHASE EL PASO'S GAS AHEAD OF HIGHER COST SUPPLIES. THEY ARE PREVENTED FROM BUYING THE LOWEST-COST GAS FIRST BECAUSE OF MINIMUM PURCHASE CONTRACT WITH OTHER INTERSTATE PIPELINES.

AS A CONSEQUENCE, SINCE APRIL OF 1982, SALES OF EL PASO'S GAS IN CALIFORNIA HAVE VARIED WITHIN A 24-HOUR PERIOD BY NEARLY A BILLION CUBIC FEET. THE TAKES FROM EL PASO DEPEND ON THE MARKET DEMAND REMAINING AFTER THE DISTRIBUTORS HAVE FIRST TAKEN THEIR REQUIRED MINIMUM PURCHASES OF HIGHER COST GAS.

ON MANY DAYS, EL PASO GAS AT APPROXIMATELY $3.73 PER MMBTU HAS BEEN LEFT UNPURCHASED IN THE PIPELINE IN FAVOR OF CANADIAN SUPPLIES ARRIVING AT THE CALIFORNIA BORDER AT $5 TO $8 DOLLARS PER MMBTU'S. EL PASO'S 1982 SALES DECLINED BY 650 MILLION CUBIC FEET A DAY.

IN 1982, THESE RIGIDITIES IN PIPELINE-DISTRIBUTOR CONTRACTS HAVE COST CALIFORNIA CONSUMERS MORE THAN $250 MILLION IN AVOIDABLE GAS COSTS.

HIGH PIPELINE DISTRIBUTOR MINIMUM BILLS MAY BE JUSTIFIED IN THE PARTICULAR CIRCUMSTANCES OF A GIVEN SYSTEM. LEGISLATION WHICH ARBITRARILY NULLIFIES ALL SUCH PROVISIONS MAY HARM RATHER THAN HELP THE PUBLIC INTEREST. NEVERTHELESS, EFFECTIVE LEGISLATION MUST ADDRESS RIGIDITIES AT THE MARKET END OF THE PIPELINE.

SECOND, THE HODEL BILL'S APPROACH TO PIPELINE ACCOUNTABILITY MUST BE MODIFIED. AS NOW PROPOSED IT PENALIZES INTERSTATE PIPELINES WHICH HAVE MANAGED THEIR SUPPLIES TO MINIMIZE GAS COSTS.

SINCE THE "ALLOWED RATE" IS THE AVERAGE PRICE PER MILLION BTU'S THAT A PIPELINE PAID FOR GAS DELIVERED TO IT DURING THE MONTH PRECEDING ENACTMENT, THOSE PIPELINES WHO HAVE MANAGED THEIR SUPPLY TO MINIMIZE COSTS ARE DISADVANTAGED RELATIVE TO THOSE PIPELINES WITH HIGHER COSTS. THIS IS BECAUSE THE HIGHER COSTS PIPELINES WILL HAVE A GREATER POOL OF DOLLARS WHICH WILL BE ALLOWED PASSTHROUGH. OUR STUDIES SHOW THAT OF 19 MAJOR INTERSTATE PIPELINES EL PASO'S GAS COSTS ARE IN THE LOWEST ONE-FOURTH OF SUCH PIPELINES.

FURTHER, INTERSTATE PIPELINES WILL BE SEVERELY DISADVANTAGED IN THE COMPETITION FOR NEW GAS SUPPLIES RELATIVE TO INTRASTATE PIPELINES AND OTHER NEW BUYERS WHO HAVE NO SUCH PIPELINE ACCOUNTABILITY APPLICABLE TO THEM. THIS POSES THE SPECTRE OF THE RECREATION WITH A VENGENCE OF ALL OF THE DUAL MARKET DISTORTIONS WHICH THE NGPA WAS ENACTED TO ELIMINATE IN 1978.

MOREOVER, WITH THE PIPELINE TRANSPORTATION PROVISIONS, INTRASTATE PIPELINES, DISTRIBUTORS, AND INDUSTRIAL USERS WILL NOW BE BIDDING FOR GAS SUPPLIES AT THE WELLHEAD. INTERSTATE PIPELINES, BURDENED WITH THE RISKS CREATED BY THE PASSTHROUGH LIMITATION PROVISIONS, WILL FIND IT DIFFICULT TO SECURE ADEQUATE SUPPLIES TO SERVE THEIR REMAINING SYSTEM CUSTOMERS. INTERSTATE PIPELINES MUST NOT BE DISADVANTAGED IN THEIR EFFORTS TO SUPPLY CUSTOMERS WHO CAN NOT OBTAIN THEIR OWN SUPPLY.

ONE WAY TO REACH A BETTER COMPETITIVE BALANCE BETWEEN WELLHEAD BIDDERS WHILE STILL HOLDING INTERSTATE PIPELINES TO A HIGHER DEGREE OF ACCOUNTABILITY WOULD BE TO LIMIT GUARANTEED PASSTHROUGH ONLY TO GAS PURCHASE COSTS WHICH DO NOT EXCEED THE "GAS CAP".

EL PASO SUPPORTS THE TWO MODIFICATIONS TO THE PASSTHROUGH PROVISION SUGGESTED BY FERC CHAIRMAN BUTLER IN HIS TESTIMONY BEFORE THIS COMMITTEE ON MARCH 12, 1983, NAMELY THAT 1) THE COMMISSION BE EMPOWERED TO APPROVE RATES BASED ON REASONABLE PROJECTIONS OF FUTURE GAS COSTS; AND 2) PIPELINES BE ALLOWED TO RECOVER, IN ONE WAY OR ANOTHER, LEGITIMATE PURCHASED GAS COSTS INCURRED BEFORE THE COMMISSION'S FINAL DECISION.

THIRD, NATURAL GAS OWNED AND PRODUCED BY PIPELINES SHOULD BE GRANTED PARITY TREATMENT AT THE WELLHEAD WITH GAS PRODUCED BY OTHERS.

NATURAL GAS PRODUCED AND OWNED BY GAS PIPELINE COMPANIES IS A SMALL BUT IMPORTANT PART OF THE NATION'S DOMESTIC GAS SUPPLIES.

ACCORDING TO ONE DEPARTMENT OF ENERGY REPORT, PIPELINE PRODUCTION CONSTITUTED APPROXIMATELY THREE PERCENT OF THE NATION'S TOTAL PRODUCTION IN THE 1979-1981 PERIOD. FOR COMPARISON 1982 GAS IMPORTS FROM CANADA COMPRISED APPROXIMATELY FOUR PERCENT OF THE GAS CONSUMED IN THE U.S.

ON INDIVIDUAL PIPELINE SYSTEMS THE SIGNIFICANCE OF PIPELINE-PRODUCED GAS MAY BE MUCH GREATER. AS I STATED AT THE OUTSET OF MY TESTIMONY, PIPELINE-PRODUCED GAS REPRESENTS EIGHTEEN PERCENT [679 MMCF/D] OF THE NATURAL GAS PROJECTED TO BE AVAILABLE TO EL PASO'S SYSTEM DURING 1983.

THE FAILURE OF CONGRESS IN 1978 TO *EXPLICITLY* INCLUDE PIPELINE PRODUCED GAS WITHIN THE NGPA'S "FIRST SALE" DEFINITION HAS PRODUCED DEBATE REGARDING WHETHER CONGRESS INTENDED IN 1978 TO APPLY THE NGPA'S PROVISIONS TO ALL GAS PRODUCED WITHIN THE UNITED STATES, INCLUDING PIPELINE PRODUCTION. THAT QUESTION IS NOW BEFORE THE UNITED STATES SUPREME COURT IN THE *MID-LOUISIANA* CASE.

IF *THIS* CONGRESS DETERMINES TO ESTABLISH A NATURAL GAS WELLHEAD PRICING AND PRICE DECONTROL POLICY TO COMPREHENSIVELY ADDRESS ALL PRESENT AND FUTURE NATURAL GAS PRODUCED IN THE UNITED STATES, PIPELINE PRODUCTION SHOULD BE GOVERNED AT THE WELLHEAD BY THE LEGISLATION APPLICABLE TO ALL OTHGER DOMESTIC GAS PRODUCTION. LEGISLATIVE LANGUAGE TO ACCOMPLISH THIS IS APPENDED TO MY WRITTEN STATEMENT.

INCLUSION BY *THIS* CONGRESS OF PIPELINE PRODUCED GAS INTO THE LEGISLATIVE FRAMEWORK PROVIDED FOR ALL OTHER DOMESTIC NATURAL GAS WILL NOT AFFECT THE SUPREME COURT'S RESOLUTION OF WHAT CONGRESS INTENDED IN 1978.

BY *EXPRESSLY* INCLUDING PIPELINE PRODUCTION AS A "FIRST SALE", CONGRESS WOULD NOT BE GRANTING PIPELINE COMPANIES A "BLANK CHECK" IN PRICING THEIR OWN PIPELINE PRODUCTION AT THE WELLHEAD FOR RATEMAKING PURPOSES. IN ORDER FOR THE WELLHEAD PRICE ASSIGNED BY A PIPELINE TO ITS OWN GAS PRODUCTION TO BE FLOWED THROUGH IN ITS RATES, THE PRICE WOULD HAVE TO SATISFY SEVERAL TESTS: FIRST, THE PIPELINE MUST DEMONSTRATE TO THE FERC'S SATISFACTION THAT IT HAS NOT AGREED TO PRICE THE PIPELINE-PRODUCED GAS AT A DIFFERENT PRICE; SECOND, IF THE GAS PRODUCTION IS SUBJECT TO PRICE CONTROLS, THE PRICE CANNOT EXCEED THE RELEVANT NGPA MAXIMUM LAWFUL PRICE; THIRD, THE WELLHEAD PRICE ASSIGNED COULD NOT EXCEED THE PRICE AGREED TO IN COMPARABLE SALES BETWEEN NON-AFFILIATED SELLERS AND BUYERS IN ARMS-LENGTH TRANSACTIONS; FINALLY, THE WELLHEAD PRICE ASSIGNED TO PIPELINE PRODUCTION MUST BE SENSITIVE TO MARKET SIGNALS. THE PIPELINE MUST CAREFULLY CONSIDER WHETHER THE WELLHEAD PRICE ASSIGNED TO ITS OWN PIPELINE PRODUCTION WHEN ADDED TO ITS OTHER GAS COSTS AND ITS TRANSMISSION COSTS, WILL ALLOW ITS PRODUCT TO BE SOLD IN THE MARKETPLACE.

THIS CONCLUDES MY PREPARED STATEMENT. I'LL BE HAPPY TO TRY TO ANSWER ANY QUESTIONS YOU MAY HAVE.

Pipeline Production

1. Amend Paragraph (20) of Section 2 as follows:

   (20) Sale. --The term "sale" means any sale, exchange, or other transfer for value and, with respect to natural gas owned and produced by any pipeline, includes the intracorporate transfer of such natural gas.

2. Amend Paragraph (21) of Section 2 as follows:

   (21) First Sale. --
   (A) General Rule. -- The term "first sale" means any sale of any volume of natural gas -

   (i) to any interstate pipeline, (or) intrastate pipeline, or to the transmission division of a pipeline in the case of natural gas owned and produced by that pipeline:

   * * * *

3. Amend Section 601(b)(i)(A) as follows:

   (A) First Sales. -- Subject to paragraph (E), for purposes of Sections 4 and 5 of the Natural Gas Act, any amount paid (including, with respect to natural gas owned and produced by any pipeline, any wellhead value assigned by the pipeline to such natural gas) in any first sale of natural gas shall be deemed to be just and reasonable if --

   * * * *

4. Amend Section 601(c)(2) as follows:

   (2) Recovery of Just and Reasonable Prices Paid. -- For purposes of Sections 4 and 5 of the Natural Gas Act, the Commission may not deny any interstate pipeline recovery of any amount paid with respect to the purchase of natural gas (including with respect to natural gas owned and produced by any pipeline, any wellhead value assigned by the pipeline to such natural gas) if --

   * * * *

Explanation

Amendments to NGPA Section 2. Definitions, paragraphs (20) and (21):

The above amendments prospectively expand the current NGPA definitions of "sale" and "first sale" to expressly include domestic natural gas owned and produced by pipeline companies. These amendments do not affect the resolution of the question presently pending before the United States Supreme Court in the *Mid-Louisiana* case regarding whether Congress in 1978 implicitly applied the NGPA to pipeline production.

By the current natural gas legislation amending the NGPA of which these amendments are a part, Congress is establishing a natural gas wellhead pricing and price decontrol policy intended to comprehensively address all present and future natural gas produced in the United States. The described amendments of the "sale" and "first sale" definitions insure that pipeline production is to be governed in the future by the same national energy policy applicable to all other domestic gas production.

Amendments to NGPA Sections 601(b)(i)(A) and 601 (c)(2):

The above amendments to Title VI of the NGPA expressly provide the terms and conditions under which, *inter alia*, the well head value assigned by a pipeline to its pipeline owned and produced gas shall be deemed to be just and reasonable for purposes of recovery in interstate pipeline rates regulated by the Federal Energy Regulatory Commission under the Natural Gas Act.

By these clarifying amendments, Congress does not grant pipeline companies unlimited discretion in assigning a value to their pipeline production for ratemaking purposes. In order for the value assigned by a pipeline to its own gas production to be deemed just and reasonable under the Natural Gas Act, NGPA Section 601(b)(i)(A), as amended, provides that the assigned value cannot exceed the relevant NGPA maximum lawful price, where applicable. Moreover, the values assigned by an interstate pipeline to both its own price-controlled and price-decontrolled production will continue to be subject to the affilated entities limitation of Section 601(b)(1)(E) as measured by comparable sales between non-affiliates in arms-length transactions. Finally, the pipeline will consider the market demand for gas delivered from its pipeline system at the price which will result, in part, from the wellhead value which it decides to assign to its own pipeline production.

Senator DOMENICI. Senator Ford, I think we will just take the witnesses before we inquire.

Senator FORD. I have glanced at most of the statements, and I have some questions for each one of them.

Senator DOMENICI. Mr. Lambert, vice president of Gas Supply of the Gas Co. of New Mexico—we have your statement. It will be made a part of the record, and Mr. Derrick, yours will be made a part, including the addendum.

Mr. DERRICK. Thank you, sir.

STATEMENT OF MICHAEL H. LAMBERT, VICE PRESIDENT, GAS CO. OF NEW MEXICO

Mr. LAMBERT. Thank you very much for this opportunity to express our views with respect to the pending natural gas legislation.

Gas Co. of New Mexico, as the supplier of natural gas to most of the major communities in New Mexico, is vitally concerned about the impact of legislation on the natural gas industry in the State.

Gas Co.'s operations in New Mexico are different from typical local distribution companies' operations in that a majority of its gas supply is purchased at the wellhead or field-delivery points from independent producers, although a significant portion of its gas supply is purchased from interstate pipeline suppliers, primarily El Paso Natural Gas. Thus Gas Co. is directly impacted by legislation that affects both the producer-purchaser and the pipeline-distributor relationships.

Gas Co. has historically taken the position that the interests of New Mexico and the country are best served by total deregulation of pricing of natural gas at the wellhead and the elimination of legislatively imposed or other artificial constraints. Gas Co. remains firm in this position. Total wellhead deregulation would enable all companies, whether intrastate or interstate, to compete on an equal basis in the acquisition of new gas supplies and would help alleviate the severe market disordering problems presented by partial deregulation. We feel that the marketplace, not Government, is the most efficient allocator of resources.

Gas Co. is also concerned about the potential market disruptions and the impact on consumers caused by any attempt to undo 30 years of wellhead pricing regulation. The issues involved in the debate on deregulation of natural gas are incredibly complex, and we urge Congress to continue its careful analysis and consideration of all proposed legislation in order to minimize this impact of deregulation on natural gas producers, transmission companies, distribution companies, consumers, and the economy.

Of particular concern to Gas Co. is the impact of national legislation on our ability to compete for adequate peak day and long-term supplies of natural gas at reasonable costs and our ability to seek new markets within and outside the State of New Mexico. Specifically the abrogation of contract provision contained in the administration's proposed legislation which is erroneously labeled a market-out provision presents a serious threat to the certainty of natural gas supply for Gas Co.'s consumers. Gas Co. could theoretically lose its entire wellhead supply of natural gas that it has strived for over the past 50 years to acquire.

The imposition of such risk and uncertainty on a public utility obligated to render essential service to the public and subject to the regulation in the public interest is totally unreasonable and unacceptable. If the intent of Congress is to free the parties to negotiate new contracts, then a true market-out provision with the right of first refusal granted to both parties is potentially the appropriate mechanism. With a right of first refusal, a purchaser would at least have the opportunity to compete for the retention of its existing gas supplies and a seller would be prevented from abrogating its contract and withholding its supplies unreasonably from the marketplace.

A second major concern of the Gas Co. with respect to the administration's proposed legislation is the conditions under which a purchaser can be required to transport gas for a seller. Any mandatory transportation by a purchaser should be limited to a best effort basis by the purchaser in order that such transportation obligation not jeopardize the purchaser's ability to serve the full requirements of both its existing and future new customers.

Also the rate to be collected by the purchaser for this mandatory transportation service must allow full recovery of the purchaser's true cost of transportation in addition to the proposed incentive rate that would be retained by the purchasers. Mandatory transportation service would likely increase the level of the purchaser's operating and maintenance expenses above the level of such expenses used in designing any previously approved transportation rate.

Failure to consider increased expenses attributable to mandatory transportation services would result in an unfair imposition of costs on the purchaser's existing customers or upon the purchaser itself.

The final point that I would like to make today is that the legislatively permitted contract provisions must be responsive to widely varying market pressures both upward and downward. Indefinite price escalators, take or pay provisions, and other similar pricing provisions that were designed and included in gas-purchase agreements during periods when Government regulation of prices has been extensive but which now do not fit any supply environment being considered by the new legislation must be addressed or eliminated in order to prevent ever-escalating prices in today's marketplace.

In conclusion, the transition to total deregulation will be difficult for everyone in the natural gas industry, and careful scrutiny of any proposed legislation is necessary to minimize the impact on any one segment.

However, total deregulation is the proper course for New Mexico and the country. Thank you, Mr. Chairman, for the opportunity to present our views here.

[The prepared statement of Mr. Lambert follows:]

UNITED STATES SENATE

Committee on Energy and Natural Resources

Pending Natural Gas Legislation

Washington, D. C.

March 22, 1983

Prepared Comments of Michael H. Lambert, Vice President, Gas Company of New Mexico

Thank you very much for this opportunity to express our views with respect to pending natural gas legislation. Gas Company of New Mexico, as the supplier of natural gas to most of the major communities in New Mexico, is vitally concerned about the impact of legislation on the natural gas industry in New Mexico. Gas Company's operations in New Mexico are different from typical local distribution company operations in that a majority of its gas supply is purchased at wellhead or field delivery points from independent producers, although a significant portion of its gas supply is purchased from interstate pipeline suppliers, primarily El Paso Natural Gas Company. Thus, Gas Company is directly impacted by legislation that affects both producer-purchaser and pipeline-distributor relationships.

Gas Company has historically taken the position that the interests of New Mexico and the country are best served by total deregulation of pricing of natural gas at the wellhead and the elimination of legislatively-imposed or other artificial market constraints. Gas Company remains firm in this position. Total wellhead deregulation would enable all companies whether intrastate or interstate to compete on an equal basis in the acquisition of new gas supplies and would help alleviate the severe market disordering problems presented by partial deregulation. We feel that the marketplace, not government, is the most efficient allocator of resources.

Gas Company is also concerned about the potential market disruptions and the impact on consumers caused by any attempt to undo thirty years of wellhead price regulation. The issues involved in the debate on deregulation of natural gas are incredibly complex, and we urge Congress to continue its careful analysis and consideration of all proposed legislation in order to minimize the impact of deregulation on natural gas producers, transmission companies, distribution companies, consumers, and the economy.

Of particular concern to Gas Company is the impact of national legislation on our ability to compete for adequate, peak-day and long-term supplies of natural gas at reasonable costs and on our ability to seek new markets within and outside New Mexico. Specifically, the abrogation of contract provision contained in the Administration's proposed legislation, which is erroneously labeled a "market-out" provision, presents a serious threat to the certainty of natural gas supply for Gas Company's customers. Gas Company could theoretically lose its entire wellhead supply of natural gas that it has strived over the past fifty years to acquire. The imposition of such risk and uncertainty on a public utility--obligated to render essential service to the public and subject to regulation in the public interest--is totally unreasonable and unacceptable. If the intent of Congress is to free the parties to negotiate new contracts, then a true market-out provision, with the right of first refusal granted to both parties, is potentially the appropriate mechanism. With a right of first refusal, a purchaser would at least have the opportunity to compete for retention of its existing gas supplies, and a seller would be prevented from abrogating its contract and withholding its gas supplies unreasonably from the marketplace.

A second major concern of Gas Company with respect to the Administration's proposed legislation is the conditions under which a purchaser can be required to transport gas for a seller. Any mandatory transportation by a purchaser should be limited to a "best efforts" basis by the purchaser in order that such transportation obligation not jeopardize the purchaser's ability to serve the full requirements of both its existing and future new customers. Also, the rate to be collected by the purchaser for the mandatory transportation service must allow full recovery of the purchaser's true cost of transportation, in addition to the proposed incentive rate that would be retained by the purchaser. Mandatory transportation service would likely increase the level of the purchaser's operating and maintenance expenses above the level of such expenses used in designing any previously approved transportation rate. Failure to consider increased expenses attributable to mandatory transportation services would result in an unfair imposition of costs on the purchaser's existing customers or upon the purchaser itself.

The final point that I would like to make today is that the legislatively permitted contract provisions must be responsive to widely varying market pressures both upward and downward. Indefinite price escalators, take-or-pay provisions, and other similar pricing provisions that were designed and included in gas purchase agreements during periods when government regulation of prices has been extensive, but which now do not fit any supply environment being considered by new legislation must be addressed or eliminated in order to prevent ever-escalating prices in today's marketplace.

In conclusion, the transition to total deregulation will be difficult for everyone in the natural gas industry, and careful scrutiny of any proposed legislation is necessary to minimize the impact on any one segment. However, total deregulation is the proper course for New Mexico and the country. Thank you.

Senator DOMENICI. Thank you very much, Mr. Lambert. We welcome Senator Nickles and Senator Warner to the hearing, and if you have any particular time problem and want to inquire, either of you, you are free to do so. We have one more witness and then we will open it up. Is that all right?

Senator NICKLES. That's fine.

Senator DOMENICI. Mr. Yates, you may proceed.

STATEMENT OF GEORGE YATES, VICE PRESIDENT, NEW MEXICO INDEPENDENT PETROLEUM ASSOCIATION, ACCOMPANIED BY ALBERT GREER, FARMINGTON, N. MEX.

Mr. YATES. Thank you, Mr. Chairman. My name is George Yates. I am an independent petroleum producer and operator from Roslyn, N. Mex. I am here representing the Independent Petroleum Association of New Mexico, along with Mr. Greer from Farmington, N. Mex.

The Independent Petroleum Association of New Mexico consists of 700 members from throughout the State. We represent independent producers as well as royalty owners. We represent producers I might add that have all classifications of natural gas, both old and new.

The philosophy of our association is complete decontrol of natural gas. It does not necessarily follow that we support all provisions in Senate bill 615. The President and Secretary Hodel are to be commended for taking the initiative to get a serious decontrol proposal on the table, and our critical evaluation of certain elements is offered in the same spirit and for the same purpose as the bill—to enable the natural gas industry to supply all kinds of consumers with adequate supplies of natural gas at reasonable prices.

We wish to address through this testimony problems in Senate bill 615 and the interrelated areas of contract abrogation, the gas cap, and passthrough provisions. I wish, however, to first describe the New Mexico independents' perception of the causes of price increases that have added controversy, consumer distrust of the natural gas marketplace and caused some divisions between producers and the pipeline.

There are numerous voices that attempt to blame NGPA ceiling prices for current high prices at the burnertip and resulting loss of markets. The facts are much more complicated than that. The price of newly-contracted gas is down at the wellhead. The producer price index for February released by the Bureau of Labor Statistics last Friday shows that during the 3-month period of December, January, and February, the producer price for natural gas declined three tenths of 1 percent. This means that the average wellhead price paid in February was three tenths of 1 percent less than the average wellhead price paid in November.

Ceiling prices set by NGPA are ceiling prices, not supportive floors. Recent wellhead contracts for new gas reflect markets, not ceiling prices, and almost all recent contracts contain price adjustment clauses which allow pipeline purchasers to reduce contract prices unilaterally to reflect reductions in market value.

Other clauses which contribute to the relative value of contracts have also become less favorable to the producer. We know of no exception in New Mexico to the statement that the value of new gas in the State has dropped at the wellhead. We believe it to be true nationwide with the result that cost to the consumer is being lowered and will continue to be reduced as these newer contracts become a greater part of the mix of flowing gas stream. This lower consumer cost is coming about by the operation of market forces in natural gas producing areas. We suggest that the gas cap and the restrictive passthrough provisions in Senate bill 615 are not valid replacements for market forces and will reduce available supplies of gas over time.

Recent price increases at the burnertip are largely the result of fewer units of gas-amortizing transportation costs. The obvious solution to our present natural gas pricing problem is to sell more gas. We fully support the administration's attempt to increase the market for natural gas by including repeal of title II of NGPA and repeal of the Fuel Use Act.

Senator **Warner**. Mr. Chairman, if I could exercise an option?

Senator **Domenici**. Of course, Senator Warner.

Senator **Warner**. The statement prepared by this witness on the Independent Petroleum Association is before us, and on page 10 you draw a parallel to a situation about the abrogation of these take and pay contracts with home mortages.

This is an area which troubles me a great deal as a member of the Bar of my State. That is really the District of Columbia, but that is irrelevant. I certainly have a background in law, and I am concerned about the fact of the Congress abrogating these contracts, and you draw the parallel, and I quote, "Should the Congress endorse the purported elegance of this approach, we might suggest applying this theory to liberate all existing home mortgage contracts so that interest on new house mortgates might fall as a result . . ." and so forth.

What is the history of Congress doing comparable actions like this?

Mr. **Yates**. Senator, I don't think I can answer that question. Of course, the question has been asked of whether this action is constitutional. I am not an attorney. Attorneys have told me that it might be constitutional, so I really can't tell you.

Senator WARNER. Well, we will be looking at that, and I thank the witness and thank the chairman.

Senator DOMENICI. You can proceed. Senator Dole had a proposal——

Senator FORD. I was saying we've an amendment on the floor right now to reduce interest rates below 8 percent.

Senator DOMENICI. We've got to be fair. He didn't really say that. He said the interest deduction remains in effect unless we do that.

Senator FORD. He said it doesn't go into effect as long as——

Senator WARNER. Anyway, we will debate that tonight.

Senator FORD. I hope not. Should I bring my lunch or dinner?

Senator DOMENICI. We are going to solve that problem.

Senator FORD. We've got a good horse for Senator Melcher to ride.

Senator DOMENICI. Yes, excuse us for digressing. Go ahead.

Mr. YATES. I appreciate the comments of the committee. It helps move me into the next topic of this discussion which is contract abrogation.

The IPA of New Mexico strongly disagrees with the inclusion of a contract abrogation provision in natural gas legislation. The proposed legislation permits the abrogation of any gas purchase contract by either buyer or seller during the period from January 1, 1985 to January 1, 1986. Contracts governing the sale of natural gas are usually quite complex and include many provisions other than price which are of concern to both buyer and seller and which were negotiated voluntarily.

It is one thing for the Government to allow buyer and seller freedom to renegotiate contracts. It is quite another to allow those contracts to be abrogated and in almost libertine fashion deny the existence of any mutual obligations and responsibilities. The natural gas industry which has quite naturally existed through long-term gas sales contracts cannot smoothly adjust to uncertainty as their contractually dedicated reserves are suddenly shaken loose from previous obligations.

With passage of such a bill, gas purchasers will focus their attention on protection of their currently contracted lower priced supplies. Given the number of contracts involved, the complexity of the renegotiation task, and the seriousness of the threatened abrogation, we don't believe that focus will include the acquisition of newly discovered reserves. These older supplies are not only priced lower than new supplies. They have production facilities in place and have years of production, performance and engineering data causing the contracted gas to be a better buy at much less risk under contract renegotiation than the acquisition of more speculative supplies of gas discovered by independent producers as the result of wildcat wells.

Through the complex relationship of the abrogated lower priced contracts with the gas cap and passthrough provision in this bill, the monetary focus will also be on old reserves. With pipeline protection of existing dedication becoming a national first priority after pipelines take care of their old affiliated gas, prices for newly discovered gas will certainly be lower than that required to elicit new supplies. This will result we firmly believe in unavoidable and inevitable shortages of natural gas within a few years.

The certainty of a contract abrogation option in the future would invalidate de facto obligations under existing contracts as soon as the bill is enacted.

The take or pay obligations of gas contracts when analyzed in light of the 1985 right to breach contracts under S. 615 creates a potentially unique and frightening situation for independent producers in New Mexico. Take or pay provisions would be better labeled pay now and take later. That is because gas paid for and not taken when paid for may be taken later. When a contract is abrogated under this bill's authority, the proposed legislation specifies there will be a settlement between the parties. A producer would be forced to return money previously received for gas not yet taken. The take or pay provision, so important to a producer as an incentive to drill the well, is not only lost to the producer at the time the contract is breached in 1985, but retroactively as well.

The next conclusion is obvious. Any pipeline will be in the position immediately upon passage of the legislation to fail to perform the take obligations of the contract, knowing full well that its nonperformance will be given the stamp of approval when the contract is abrogated in 1985. This amounts to statutorily approving a breach of such provisions completely immunized from normal contract remedies. The resulting uncertainty will in our judgment terminate current contract negotiations for new supplies as buyers and sellers feel their way in the unnatural world where contracts, obligations and commitments vanish with the will of Congress.

Those independents who responded to their country's need for natural gas reserves by risking their resources on new gas supplies with the encouragement of NGPA will once again find the carrot of incentive price has disappeared not because of the operation of natural market forces but due to artificial gas supply and market manipulation.

In conclusion, the combination of the abrogation provision, gas cap and passthrough provisions provide theoretical price equilibrium in a closed system. This bill trades price regulation at the wellhead for price regulation of the pipeline. It is a closed system. It is not a complete deregulation bill. That system in our opinion will be more focused on existing reserves than on finding new gas reserves and if our judgments are correct will lead us into another shortage.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Yates follows:]

PREPARED STATEMENT
OF THE
INDEPENDENT PETROLEUM ASSOCIATION
OF NEW MEXICO

SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

MARCH 22, 1983

I. INTRODUCTION

The Independent Petroleum Association of New Mexico ("IPANM") is an association of independent oil and gas producers operating in the State of New Mexico. It was established in 1979, largely out of response to the enactment of the Natural Gas Policy Act of 1978 ("NGPA"), to allow independent producers in New Mexico to participate more effectively in proceedings such as today's hearing. Since its formation in 1979, the IPANM has now grown to the point that it has 700 independent producer members from all parts of the State.

The IPANM greatly appreciates this opportunity to present its views to the Senate Energy Committee on the critically important matter of natural gas legislation. We thank the Committee and its staff for this additional day of hearings. We feel that the perceptions of independent producers who will be directly affected by legislative amendments will be beneficial to the Committee and its staff in your efforts to determine the best action to take on proposed natural gas legislation.

We will present those perceptions by first stating the IPANM's views on several issues we feel are greatly misunderstood by the Congress and the general public. Unfortunately, these generally held misconceptions can form the base for legislative action which would be inappropriate, at best, and counter-productive, at worst.

Following that we will discuss the IPANM's reaction to S.615, developed and proposed by the Reagan Administration. In that presentation we will first discuss those elements we feel are inappropriate or undesirable and then we will discuss those elements we feel would be of benefit. We realize that S.615 is a complex legislative measure, the various components of which are related to, and dependent on, each other. Nonetheless, we feel strongly that several of those components must be closely and critically examined because, in IPANM's view, they could lead to another natural gas shortage with, at best, only a temporary price reduction for consumers.

The President and the Secretary of Energy are to be commended for taking the initiative to get a serious legislative decontrol proposal on the table, and our critical evaluation of certain elements is offered in the same spirit and for the same purpose of the bill -- to enable the natural gas industry to supply all kinds of consumers with natural gas at acceptable prices. This goal cannot be just a short-term goal, that is, to lower prices today or next year, but it must ensure sufficient long-term supplies to prevent a reoccurrence of the shortage of the mid-1970's.

II. CAUSES OF CONSUMER PRICE INCREASES WHILE GAS SUPPLIES ARE ABUNDANT

A. Wellhead Price Increases Have Not Been the Most Important Cause of Consumer Price Increases

There is a popular misconception that recent consumer price increases during a period of abundant supplies are due entirely, or primarily, to ever increasing wellhead prices locked in an upward mode by the NGPA. In large part, this notion has been fostered by transmission and distribution companies and their associations asserting that the average wellhead prices, as a percentage of the average consumer price, has been increasing rapidly in recent years and months. The American Gas Association ("AGA"), for example, makes much of the fact that their studies show that "the price paid for gas at the wellhead rose from less than 45% of the total national average retail gas bill in 1977 to 55% in 1982." The AGA's conclusion is that "the most important factor in determining the retail price of gas paid by the consumer" is the wellhead price and its increase.

This attempt to shift the focus of concern fails to even acknowledge where wellhead prices were in 1977 and where transportation and distribution costs were at that time. The AGA's own figures show that, in 1982 dollars, the average price at the wellhead in 1977 was only $1.17 per MMBtu, while middlemen costs were $2.18 per MMBtu. This ratio was, of course, due to the Natural Gas Act price controls applied at the wellhead and it should not be accepted as the norm or as ideal for any purpose. The fact that the producer's share of the final price has gone up as wellhead price controls have been lifted should come as no surprise and should not be used as the basis for setting national pricing policies.

Information in the public record shows that during some recent periods, middlemen cost increases have exceeded producer price increases for those periods. For example, from May, 1981, to May, 1982, the average wellhead price for all U.S. gas rose by 34 cents per Mcf, while the average burner tip price rose by $1.07. Stated another way, less than 40% of the increase in the burner tip price during that 12-month period was due to an increase in the average price paid to producers. The same proportion holds true for the companies of the $5.31 per Mcf price paid by the average residential user in April, 1982; $3.04 went to transportation and distribution middlemen and only $2.27 went to producers. The Energy Information Agency (EIA) produced a study showing that in mid-1982, while residential consumers were paying an average of $5.77 per MMBtu for gas, interstate pipelines were paying producers an average of only $2.35 per MMBtu, showing that at that time about 60% of the price paid by consumers for natural gas goes to middlemen rather than producers.

The Producer Price Index for February, released by the Bureau of Labor Statistics last Friday shows that during the 3-month period of December, January and February, the producer price for natural gas declined by 0.3%. This means that the average wellhead price paid in February was 0.3% lower than the average wellhead price paid in November.

Whatever the current ratio between producer prices and middleman costs, it is obvious that the reduction in total gas markets, with huge fixed costs of service by transporters and distributors (at a guaranteed rate of return) to be spread over smaller quantities of gas, has resulted in an increase in the cost per Mcf or per MMBtu to the consumer even when there has been no price increase to the producer.

B. Value to Producers of New and Incentive Gas is Declining and is Below NGPA Price Levels

One of the most difficult aspects of attempting to focus properly on natural gas problems is caused by the time lag in acquiring price and cost data and information on wellhead pricing passthroughs. Therefore, it is extremely important to observe what is happening now in the natural gas producing fields of New Mexico which we feel reflects nationwide trends.

The value of new natural gas found in New Mexico is declining at the wellhead. This decline in value began over one and one-half years ago for deep, deregulated gas, over a year ago for incentive, tight formation gas and within the last nine months for all other categories of new gas.

The "value" of natural gas to the producer must be defined. Value, in this context, not only includes price, but it also includes non-price provisions. The consumer actually pays for the value of natural gas, not simply the price stated in the pricing provisions of the gas purchase contract. If a new contract has a market-out clause included, the value of the gas to the producer has decreased compared to an older contract which does not have a market-out clause. Once the pipeline companies began to lose gas markets due to the recession and lower competing fuel prices, the market-out clause became a standard provision in natural gas contracts. As far as we are aware, nearly every interstate pipeline company in New Mexico has exercised market-out clauses to reduce wellhead prices. We believe the same to be true nationwide.

If a new contract has a lower take-or-pay obligation, more stringent pressure and compression requirements, longer term commitments, etc., then the gas under the new contract has decreased in value from previous contracts existing only a year or two ago. We know of no exception in New Mexico to the statement that the value of new gas in the State has dropped at the wellhead. We believe it also to be true nationwide, with the result that the cost to the consumer is being lowered and will continue to be reduced as these newer contracts become a greater part of the mix of the flowing gas stream. This lower consumer cost is coming about by the operation of market forces in the natural gas producing areas.

C. Preferential Treatment of Certain High-Cost Gas has Contributed to Consumer Price Increases

It is important to note that many pipeline companies are affiliated with exploration and production companies and that gas purchase agreements are commonly executed by and between pipeline companies and their producing affiliates in much the same manner as such agreements are executed by and between pipeline companies and non-affiliated companies.

As the market for natural gas has declined, pipeline company loads have been reduced and, consequently, gas takes have been cut back. Confronted with this market environment, pipeline companies have had to make decisions regarding (1) the amount of gas to be taken from their sources of supply, (2) the sources from which this amount of gas should be taken and (3) the mix of gas to be taken. Many pipeline companies have made decisions on these matters which have lead to inequities, both to producers and consumers. Specifically, much high-cost and tight formation gas, which commands relatively high prices under the Natural Gas Policy Act of 1978, has been taken by pipeline companies from producing affiliates while relatively low cost gas reserves, owned by non-affiliated companies, have been left in the ground. This preferential treatment accorded production affiliates has resulted in the needless increase in cost of natural gas to the consumer at a time when deliverable low cost gas reserves are available, but consciously not taken.

In addition to the producer affiliate problem, imports of high-cost natural gas and liquified natural gas have resulted in certain market inequities. Oil and gas producers owning relatively low cost deliverable gas reserves are finding their sales displaced by significantly higher priced Mexican and Canadian natural gas and by foreign LNG. The result of such displacement is that the consumer is paying significantly higher prices than would be necessary if otherwise available low priced and deliverable natural gas would be moved to them.

III. SPECIFIC COMMENTS ON CERTAIN FEATURES OF S.615

A. Features of S.615 IPANM Does Not Support

1. Unilateral Contract Abrogation

The proposed legislation permits the abrogation of any gas purchase contract by either buyer or seller during the period from January 1, 1985 to January 1, 1986.

The IPANM strongly disagrees with the inclusion of a contract abrogation provision in natural gas legislation.

Contracts governing the sale of natural gas are usually quite complex and include many provisions other than price which are of concern to both the buyer and seller and which were negotiated voluntarily. It is one thing for the government to allow buyer and seller the freedom to renegotiate contracts. It is quite another thing to allow those contracts to be abrogated and in almost libertine fashion deny the existence of any mutual obligations and responsibilities.

The natural gas industry which has quite naturally existed through long term gas sales contracts cannot smoothly adjust to the uncertainty as their contractually dedicated reserves are being suddenly shaken loose from previous obligations. Should the Congress endorse the purported elegance of this approach, we might suggest applying this theory to liberate all existing home mortgage contracts so that interest on new house mortgages might fall as a result, notwithstanding the consequence penalty paid by the homeowner with an older, lower-rate mortgage. The obvious inequities of hypothetical contract abrogation in the housing industry are similar to resulting inequities in the natural gas industry, should this bill pass in its present form.

With passage of such a bill, gas purchasers will focus their attention on protection of their currently contracted lower-priced supplies. Given the number of contracts involved, the complexity of the renegotiation task and the seriousness of the threatened abrogation, we don't believe that focus will include the acquisition of newly discovered reserves. These older supplies are not only priced lower than new supplies, they have production facilities in place and have years of production performance and engineering data causing the contracted gas to be a better buy, at much less risk under contract renegotiation than the acquisition of more speculative supplies of gas discovered by independent producers as the result of wildcat wells.

Through the complex relationship of the abrogated lower priced contracts with the gas cap and passthrough provision in this bill, the monetary focus will also be on old reserves. With pipeline protection of existing dedications becoming a national first priority (after pipelines take care of their old affiliated gas), prices for newly discovered gas will certainly be lower than that required to elicit new supplies. This will result, we firmly believe, in unavoidable and inevitable shortages of natural gas within a few years.

The certainty of a contract abrogation option in the future would invalidate de-facto obligations under existing contracts as soon as the bill is enacted.

The take-or-pay obligation of gas contracts, when analyzed in light of the 1985 right to breach contracts under

S.615 creates a potentially unique and frightening situation for independent producers. Take-or-pay provisions would be better labeled pay-now and take-later, i.e., gas paid for and not taken when paid for may be taken later. When a contract is abrogated under this bill's authority, the proposed legislation specifies there will be a settlement between the parties. A producer would be forced to return money previously received for gas not yet taken. The take-or-pay provision, so important to a producer as an incentive to drill the well, is not only lost to the producer at the time the contract is breached in 1985, but retroactively as well.

The next conclusion is obvious. Any pipeline will be in the position, immediately upon passage of the legislation, to fail to perform the take obligations of the contract, knowing full well that its non-performance will be given the stamp of approval when the contract is abrogated in 1985. This amounts to statutorily approving a breach of such provisions, completely immunized from normal contract remedies. The resulting uncertainty will, in my judgment, terminate current contract negotiations for new supplies as buyers and sellers feel their way in the unnatural world where contracts, obligations and commitments vanish with the will of Congress.

Those independents who responded to their country's need for new natural gas reserves by risking their resources on new gas supplies with the encouragement of NGPA will once again find that the carrot of incentive price has disappeared. Not because of the operation of natural market forces, but due to artificial gas supply and market manipulation.

As previously explained, the proposed legislation permits the termination of gas purchase contracts by either the buyer or the seller during a one-year period beginning January 1, 1985 and ending January 1, 1986. At that time, new contracts can be negotiated with the same buyer, any other pipeline company or any end-user of the product. On January 1, 1985 the natural gas environment will be such that purchasers will be clamoring to terminate gas purchase agreements principally applicable to new gas and to renegotiate gas purchase agreements principally applicable to old gas. Only those owners of large reserves of old gas will be able to negotiate favorable contracts. Independent oil and gas producers, on an individual basis, will not have the amount of reserves, and therefore the bargaining power, to compete for the buying market and will require grouping of gas reserves (providing, of course, such grouping meets the Anti-Trust laws). Such producers will thereafter be attempting to market their gas through brokers and this will create another layer of cost in providing gas to the consumer. This is one of the reasons IPANM feels so strongly that strong, workable access provisions are so important.

In addition to these broad, more philosophical objections to contract abrogation, technical and practical problems caused by actual or impending contract abrogation abound. A few of those problems, very real problems for New Mexico independent producers, are discussed below.

Stripper well issue. There are many stripper wells in New Mexico and throughout the oil and gas producing states. Stripper wells are those wells, as defined by the Natural Gas Policy Act of 1978, which do not produce in excess of 60 Mcf per day. The provisions in the proposed legislation which would permit the immediate upper renegotiation of older gas purchase agreements would allow those increases to come about at the expense of stripper and other gas categorized under the NGPA as Section 102, Section 103 and Section 108. The NGPA gave special consideration to stripper wells, in an effort to promote the production of additional reserves, and to prevent the premature abandonment of wells. Reductions in the price for stripper well gas will result in the premature abandonment of numerous wells. An approximation of the relative numbers of stripper wells and their gas production volumes for the Northwest New Mexico area can be made from the figures supplied to the New Mexico State Oil Conservation Division by El Paso Natural Gas Company this winter (Case No. 7753 heard December 16, 1982, and February 1, 1983, relating to September 1982 production).

Listed below is relevant information for three of the four largest prorated pools in Northwest New Mexico.

	No. of Wells			Volume (MMcf/d)		
Pool	Stripper	Total	%	Stripper	Total	%
Basin Dakota	663	1923	33	19	298	6
Blanco Mesa Verde	340	1785	19	11	445	2
South Blanco Pictured Cliffs	1044	1142	91	27	36	74
TOTALS	2047	4850	42	57	779	7

Over 90% of the shallow, relatively low-cost, Pictured Cliffs wells are stripper: these small independents, heavily invested here would suffer a disproprotionate burden in roll-back of price under S.615, which would not be offset with gains from low-cost gas prices, as would be the case where producers have both lower-and high-priced gas being sold. This is even more of a problem for consumers, because the only alternative when that happens is to abandon the well and its reserves.

An ironic development will occur under S.615 relating to stripper wells that will be prematurely abandoned, since these are wells which could produce gas at prices lower than imported Canadian and Mexican gas. The situation here is much different than simply postponing the drilling of marginal reserves because the costs of development have already been made and a portion of the reserves produced. There is simply no way in the future that new wells could be drilled to recover the small remaining volumes of gas under any price that might in the future exist because such future prices will undoubtedly be limited to the cost of alternative supplies and at these prices it would be economically infeasible to drill for these remaining reserves. This means that S.615's price control scheme would doom these reserves otherwise recoverable under NGPA to be forever unavailable to the American consumer.

Indian leases. Specific problems involving Indian and federal leases are:

a. Indian leases require continuous production or they are subject to cancellation for any month in which no production occurs.

b. Both federal and Indian leases require that production be obtained in "commercial quantities" or the leases are subject to cancellation.

c. Federal leases require that royalties be computed on the "estimated reasonable value", which is customarily taken as the highest price paid in the areas for the same quality (and/or category) of gas. Under the NGPA the categorizing of gas is clear-cut. Under S.615 this will no longer be the case. Producers who have large reserves of old gas could make "trade-outs" so that such a producer could receive a high price for gas currently being developed in exchange for some agreed-upon transfer to the purchaser of a large reserve of old gas. This price then could set the "reasonable value" by which the federal royalty is computed for all producers in the field. Independent producers might be receiving a far lower price for their gas, but would nevertheless suffer the inequity of paying royalty unrelated to price received.

2. The Proposed Gas Cap

In view of IPANM's position on existing purchasing practices, we feel that any kind of gas cap is uncalled for and would serve no valid purpose. Accordingly, we oppose the gas cap, both in concept and mechanics. Certainly, since the stated purpose of the gas cap is to ensure that prices paid under NGPA gas contracts reflects actual market prices if such a provision is included, IPANM is firmly convinced that only new gas contracts, as opposed to new and renegotiated gas contracts, should be considered. Whether existing contracts cover lower-or higher-priced gas, their renegotiation would not accurately reflect the current commodity value of gas and result in unnecessary and unjustified distortions. If renegotiated contracts are included, it would certainly seem appropriate and essential to include new and renegotiated contracts for imported gas and foreign LNG.

3. Limitation on Pipeline's Ability to Passthrough Increased Purchased Gas Costs

The provisions of the Bill which would limit passthrough of purchased gas costs are much too restrictive, particularly if unilateral abrogation of contracts is maintained. Other witnesses have testified in detail about the technical inequities of those provisions, essentially that they overlook the depletion of lower-priced gas supplies and penalize the pipelines that currently are at the lower PGA levels. We endorse those criticisms and add to the observation that in this regard the Bill would move toward greater regulation rather than less and for a period of time would substitute pipeline regulation for wellhead regulation. The IPANM feels that neither that extension nor that substitution is in the long term best interests of consumers or producers, particularly as currently written.

4. Limitations on Take-or-Pay Provisions

Historically, contracts have been for a long term, such as 20 years or life of the lease, a condition required by pipeline purchasers and by the FPC/FERC. In order to justify the expense and risk of exploration and development of properties thought to be capable of natural gas production and in order to secure financing required for such expensive projects, producers must have some assurance, over the long duration of the contract, that:

a. A minimum of cash flow will be generated if the property is productive.

b. The reserves under his property will not be drained away due to lack of production at a reasonable level.

c. The purchaser will not effectively shut-in the independent's production while preferentially taking gas from other producers, particularly production affiliates of the purchasing pipeline.

The producer objectives listed above are reasonable and legitimate in view of the long term nature of natural gas purchase agreements insisted on by pipeline purchasers. The need for cash flow, based on the value of the commodity over time is the primary basis for indefinite price escalators. Pipelines would not think of entering into contracts to deliver gas at a fixed price, or even with definite price escalators, so why should they have demanded that producers be so limited.

At this point, it should be noted that under the rate regulation structure administered by the FERC, pipelines have operated essentially risk free, since they recover most costs, including purchased gas costs, and were virtually guaranteed a profit. We must maintain a healthy and stable transmission system for natural gas, but we cannot selectively eliminate irritants to one part of the industry at the expense of other parts of the industry, unless some ultimate overall benefit is achieved.

All three objectives listed previously form the bas of take-or-pay clauses. They are not irrational or unconscionable as some would have us believe. To eliminate or significantly alter those clauses would be not only to deprive the producer of his bargained for right, but reduce his cash flow below expectations, allow his reserves to be drained and ensure that pipelines can preferentially take gas from other producers, including their own affiliates, a problem partially addressed in S.615.

For these reasons, the IPANM of New Mexico does not agree that statutory reduction of take-or-pay is justified. We are, however, willing to accept the 70% limitation as specified in S.615, with some modification. If the purchaser utilizes the 70% statutory limitation to reduce takes, the entire amount of gas dedicated to that contract should become available, at .ie producer's option, for direct sale to other purchasers, with transportation required of the previous purchaser.

B. Features of S.615 IPANM Supports

1. Repeal of the Fuel Use Act and Incremental Pricing

Artificial restraints on the use of and demand for natural gas have been shown to be unnecessary and counterproductive when adequate prices can be paid to producers. The well intentioned purposes of such measures -- to parcel out this precious fuel only to its highest value uses (whatever those are) and to create a market-ordering device (whatever that is) -- have utterly failed to be achieved. In fact, those measures have been classic examples of frustration of purpose and counterproductive results. They should be recognized as such and repealed completely, regardless of anything else that transpires. Residential consumers, under any statutory framework, can only be adversely affected by laws and regulations prohibiting certain uses of gas or making it so expensive that major categories of users switch to other fuels.

C. Greater Opportunity for Direct Sales of Gas

The IPANM has endorsed the principle of equal access to transportation and distribution facilities and, therefore, supports those provisions in S.615 that allow greater access for direct sales. This is particularly important for gas as to which the pipeline purchaser has exercised a contractual or statutory right not to buy.

Beyond that, however, the IPANM feels that the development of a national market for natural gas would be beneficial to all consumers, since it would ensure that all kinds of purchasers could take advantage of the lowest priced gas they could find. S.615 takes new steps in the right direction, but those provisions need to be strengthened and improved, along the lines recommended by the Association for Equal Access to Natural Gas Markets and Suppliers ("NGEA") in its recent appearance before this Committee. Even those New Mexico independent producers who feel that they may never be able to utilize access provisions support this concept. Those producers feel that better access for direct sales would provide a more competitive market for natural gas reserves, and, would be of benefit to consumers and those producers of gas able to utilize the access provisions.

IV. CONCLUSION

The IPANM recognizes and appreciates the efforts of the Administration to present meaningful amendments to correct deficiences in the NGPA. We realize that this has involved a tremendous undertaking for purposes and objectives that would be beneficial to the natural gas industry and natural gas consumers of all kinds. We are, however, convinced that the problems we have identified and explained are so severe that these very worthwhile purposes cannot be achieved with S.615 as presently written.

Accordingly, it is the recommendation of the IPANM that this Committee restructure S.615 to amend the NGPA by eliminating the major problems with the present legislations as specified above. Of course, other revisions must be considered, consistent with the changes we recommend.

I would be pleased to answer any questions. Thank you.

Senator DOMENICI. Thank you very much, Mr. Yates. Senator Nickles is going to return and Senator Ford, when I am finished with my questions, I might have to leave to attend a chairman's meeting. I think he indicated he could stay here and preside, but I will try to.

Senator FORD. I will have to leave in about 20 minutes, so half an hour.

Senator DOMENICI. I will try to be brief. Mr. Greer, if you have anything to contribute as I question Mr. Yates, feel free to do so.

How could we find out, Mr. Yates, the broad relevancy of some of your statements? You have already pointed out that in your opinion the marketplace is having, is now reacting to the oversupply of new contracts or different than they were 3 years ago. Not only is the price coming down as you indicated, but obviously contract provisions are changing dramatically from your testimony.

Do you have any idea how many contracts we are concerned about in terms of take or pay provisions or indefinite escalators and when would they begin to phase out in terms of the prospect of renegotiation? Is there some place we could find that out?

I mean I think when you look out 3 or 4 years that you make a good point with reference to abrogation and the like if as a matter of fact the market has a way of clearing that and it is in the process. Do you know where we might find that information out on a very broad, broad basis?

Mr. YATES. Senator, I don't know if the Energy Information Agency keeps track of such provisions, but certainly members of this panel have such information as do independent associations such as our own in New Mexico.

I would like to make the point that over time the problem of indefinite price escalators is reduced through natural depletion. The process of replacement of gas supplies, replacement of depleted supplies over time, causes new gas contracts to reflect actual market conditions.

Senator **Domenici**. Mr. Yates, I have to stop you for a minute. I have been informed that there is objection to us meeting beyond 11:30 because the Senate is in session. That means we will have to recess until 12 when the Senate goes out and reconvenes. Is that correct?

Senator **Ford**. Mr. Chairman, we have a little thing we do down in Kentucky that when the witching hour arrives, you just stop the damn clock, and if you want to stop it at 11:30, I don't know anything different from that. I have been informed that the clock stopped at 11:15.

Senator **Domenici**. I have no way of being here after 12. That's the problem I have. I understand the risk we take is that we can't pay the reporter for her services.

[A discussion was held off the record.]

Senator **Domenici**. I don't want to not have the answers transcribed and I understand it is the position of the chairman of the committee that we not meet when there is objection, so we are going to be in recess for 15 minutes, and we will try our best to get the answers. If we can't, we will give you the questions and you can answer them in writing.

We stand in recess.

[Recess.]

Senator **Domenici**. The time of 12 having arrived——

Senator **Ford**. Yes, sir. I attest to that.

Senator **Domenici**. Let the record show that Senator Ford confirmed that.

Mr. Yates, you were in the process of talking about the effect of existing contract provisions and the effect of abrogation. You said something about the Energy Information Agency, and then we kind of had to get off the record, so would you proceed, and Mr. Greer, if you will come back, he wants to talk about some specific problem in one region. I would like to get that out and ask one question, and then I am going to let Senator Nickles preside.

Go ahead, Mr. Yates.

Mr. **Yates**. Senator, what we were discussing was contract provisions that have indefinite price escalators, the subject, of course, being the so-called price escalation and deregulation time. Well, I don't know whether the Energy Information Agency keeps track of particular provisions in gas contracts. A good supply of information is going to be an independent group such as ours who control the members and who, of course, are gas transporters and pipelines such as the gentlemen that are seated here with me at the panel.

I think one point that I would like to make, the contracts that have these provisions that cause concern is that as time goes on these supplies of gas covered by those contracts deplete and looking forward to deregulation date in 1985, it will be less of a problem depending upon the demand for gas certainly, but less of a problem than it will be today because less gas is affected.

Also current contracts are negotiated by pipelines and producers. It is no longer a seller's market. Contracts are negotiated with provisions that cause those contract prices as well as other provisions in those contracts which affect values to be set at lower values, including a very dominant provision we call market-out provision which causes the price of gas in a new contract to be reduced unilaterally by a gas pipeline if that price is not a market clearing price. In other words, if the market declines, then that price can decline also.

Senator DOMENICI. Let me, before I ask Mr. Greer to allude to some problems that he sees for certain kinds of wells, let me ask, what we have been doing I think in focusing on abrogation is to discuss principally the issue of price, but isn't there some other possible effects that might flow from abrogation? For instance, don't some leases require production from wells and very specifically some say from what I would remember that he can't stop production for more than *x* number of days?

Mr. YATES. I would like Mr. Greer to answer that question.

Senator DOMENICI. Could you tell us about that? And it seems to me if we are addressing one side of it we have got to protect the independent or the producer from getting that kind of a treatment if we caused the production to stop by this law.

Mr. GREER. Yes, sir. We address that briefly on pages 16 and 17 of our prepared statement. Of particular concern to us are Indian leases, and this affects northwest New Mexico more than any other area of the Nation.

We have just recently found that although there have been reports of problems with Indian leases in other States, it turns out that Indian leases regulated by the Department of the Interior, practically all of the production is in the Four Corners area of northwestern Mexico, and so this is a problem that we have that is more severe than for other areas, and one of the terms of an Indian lease is if it doesn't produce in 1 month, the lease, if it is in its extended term, is automatically terminated, so on this abrogation of contract, if a purchaser elects not to purchase our gas and we are disconnected, then we don't have a market. In 30 days we have lost our lease, and of course, we understand that perhaps provisions could be made to where the purchaser would take sympathy on us and produce the well a day or two a month or whatever until he could work out another market, but it is not that simple particularly where we are dealing with stripper wells. They may have to produce several days a month in order to meet another test that the Department of the Interior puts on leases that wells are producing in commercial quantity, and if they don't produce commercially, then again the lease is subject to termination, so these are serious problems.

Senator DOMENICI. What percentage of the production up in that area of New Mexico would have this kind of problem, Mr. Greer? Do you know?

Mr. GREER. I don't have the figures out of hand.

Senator DOMENICI. Is it significant?

Mr. GREER. It is significant.

Senator DOMENICI. Did you have some other observations with reference to that part of New Mexico and this bill?

Mr. GREER. Yes, sir. Yes, sir, I do.

Senator DOMENICI. Would you please state them?

Mr. GREER. To continue with the progress of leases and how we are going to handle, for instance, royalty, just the fact that we voluntarily enter into a new agreement for a lower price—and this we feel is definitely going to happen—the higher priced gas categories will drop in price. We will renegotiate our contracts. The price will drop, and then particularly where we have these Indian leases and Federal leases our first question is going to be what is the reasonable value of the gas on which our royalty will be based?

The Department of the Interior determines that. In the past it has not been very sympathetic. If there is some reason that they can find that gas should be priced at a higher value than the producer receives, he pays royalty not on what he actually receives but what is determined to be the reasonable value, and the problem that is created beyond that, assuming that we could even agree or that Congress if it adopts Senate bill 615 and amends it and provides some way that under these renegotiated contracts the price would drop, that the producer is protected in that he does not have to pay a royalty on a higher price than he is actually receiving, that might be one kind of relief, but it is going to be an extremely complicated problem because all of the regulations applying to leases interpretations, their values of the products—for instance, we are going to have in one prorated pool gas valued at, the 107 category, say in the range of $5, $6 per million Btu. These other wells that we have just renegotiated the price and probably we are estimating in the range of $2.25 to $2.50 per million Btu, a third or a half of what the other wells receive.

If the Department of the Interior determines that that is the fair price, the gas is the same, the quality is the same, the Btu is the same, there is no way to distinguish between it, we could be forced to pay a royalty on gas valued at two or three times what we are receiving. The Indian tribes particularly, we feel that when we drop our prices, that the obligation we have to those tribes is not going to be easily satisfied by the fact that we have voluntarily dropped the price. They are becoming more assertive in their positions of interest in their natural resources, and their royalties, so these are serious problems that perhaps if this bill is going to be enacted, that we would like to help the committee work on the solutions to them.

Another problem we have is with stripper wells. In northwest New Mexico we have a fairly high percent, as El Paso's system goes and Northwest system goes, there is a relatively high percent of stripper wells. On page 15 of our prepared statement we show some statistics about the stripper wells. For instance, although our independent producers have——

Senator DOMENICI. Would you pull the mike up? Thank you.

Mr. GREER. Although our independent producers have a mix of all kinds of gas, some of the producers in northwest New Mexico, the independents, have a rather high percent of stripper well production, and the shallow formation, the one in which wells can be drilled at the least cost, and is shown on page 15 of our statement, for one of the prorated pools, south Blanco, 91 percent of the wells are stripper wells.

When this bill, if it is enacted in its present form, becomes law, the price for stripper gas drops from its present approximately $3.50 per million Btu to $2.25 or whatever the bill is. The result will be that at the lower price some of the stripper wells will be abandoned.

Senator DOMENICI. I didn't hear that.

Mr. GREER. Some of the stripper wells then will be abandoned because they will have reached their economic limit. The NGPA recognized the problem of stripper wells being abandoned and the Nation losing reserves as a result and provided for a higher level of price for stripper wells than some of the others. Under this bill, that price level will drop. Wells which otherwise would have been producing reserves will be plugged and abandoned and those reserves now will be lost forever.

It is different from the situation in which the price drops on other wells and the producer suffers for a period of time as loss in income. Here the producer is out of business. His well is not economic. He plugs it so he is out of business. The country loses the reserves because there is no way that new wells can ever in the future, just absolutely no way that new wells can come back, be drilled in that completed field, and recover that gas, so that gas is gone forever.

Among other things, the imbalance that we see is that gas was going to market at $3.50 a thousand per million Btu. At the same time, we are importing gas from foreign sources and paying $5 to $8 a million Btu, so here we have lost forever a supply of gas and instead you might say the consumer is paying a higher price for other gas, and of course what the solution is we don't know. One possible solution that we feel would be fair is that category 108 wells be treated under Senate bill 615 in the same fashion as category 107. That would be one solution which we think this committee should look toward.

Senator DOMENICI. Thank you very much, Mr. Greer. I am going to turn the chair over to Senator Nickles. I have some questions I would have asked. I will submit them to the witnesses and if you can answer them as soon as possible, maybe 10 days, 2 weeks—we have no schedule that has been announced by the Chairman, have we? I would appreciate that, and I thank you again for coming.

Senator NICKLES [presiding]. Senator Ford, do you have any questions?

Senator FORD. I have several, and I will be very quick about them.

Mr. Derrick, apparently from your statement you agree that S. 615 penalizes prudent interstate pipelines?

Mr. DERRICK. Yes. The low cost or the low-cost pipelines it certainly does. That is not to imply that maybe a pipeline that has a higher gas cost was not prudent but certainly the ones who have been prudent and have a low-cost gas supply.

Senator FORD. I find as we look through the pipelines and their average price, delivery price, that we are going to find several in the category that when you deregulate those that have higher-priced gas are not going to be penalized nearly as much as those that have a large supply of lower-cost gas. It puts the latter, in my opinion, puts their customers in a very untenable position, and the pipeline also. There are customers who are depending on a certain price for gas and all of a sudden it goes up, then that industry or that community or whatever is going to have a setback. We are going to hear some screaming and yelling and knashing of teeth, aren't we?

Mr. **Derrick**. Yes, sir.

Senator **Ford**. Do you agree that the administration's bill could recreate a dual market?

Mr. **Derrick**. Yes, I think it will, because for example, El Paso, our gas costs about $2.84. Well, if the cap say is set at $3.10, that means that we could not purchase gas and recover the costs, so then that gas would be available to intrastates who are not under that, or industrial users or distributors or most anyone that was in the market for gas.

Senator **Ford**. Well, when you deregulate the so-called old gas and you have the cap on the interstate and the intrastate bid is 1 percent above or can go above, then the producer is going to get it, isn't he?

Mr. **Derrick**. Yes, sir.

Senator **Ford**. He would be a fool if he didn't go ahead and take as much as he could get if he has a fellow knocking on his door to get gas. That makes it a dual system as I see it in the so-called free market, but we are not in a free market. We are putting a cap on pipelines or restrictions, and also on distribution systems, and we are leaving intrastates out and the producer out so we are not being fair in my opinion. I am not holding a brief for pipelines, but what is unfair in my opinion is unfair, regardless of where it falls, and I think this is relatively unfair.

You have been shut out of markets according to your statement in California by Canadian gas?

Mr. **Derrick**. Yes, sir.

Senator **Ford**. Because of high take or pay provisions in import contracts?

Mr. **Derrick**. Yes, sir.

Senator **Ford**. Now the administration bill doesn't touch imports and they don't want to touch imports. They want to stay away from imports.

What should we do?

Mr. **Derrick**. Well, it might be that the FERC could take a look and see if the minimum bills in effect between the various pipelines and the distributors are doing an adequate job in providing the least cost mix for gas for all the consumers.

Senator **Ford**. That might——

Mr. **Derrick**. Canadian gas is coming down to California as I mentioned at $5 to $8.

Senator **Ford**. Mr. Greer alluded to that also.

Mr. **Derrick**. Yes, and it is certainly discouraging exploration and development here in this country and instead the money is flowing to Canada.

Senator **Ford**. What if FERC won't act? What do we do then?

Mr. **Derrick**. I guess you would have to mandate them to. I am not that familiar.

Senator **Ford**. Then you get into international problems and treaties or international trade agreements and all that. You begin to mix with a pretty big spoon.

Mr. **Derrick**. Well, I know one way to do it, of course, is for the domestic distributors or pipelines to renegotiate their contracts with the Canadians, but again that is not always easy.

Senator **Ford**. But the Canadians, I read an article, they told their producers to get ready to do the best they could because the United States is going to be short in 1986 anyhow. That is their judgment of our position because they look for us to come back in 1985 and 1986 and we will react again.

Mr. **Derrick**. Yes. I appreciate that.

Senator **Ford**. It seems like they stay on top of our problems and understand our problems and take advantage of us better than we try to take advantage of our own resources.

Mr. **Derrick**. It is a paradox that we are discouraging our own domestic producers from going out and exploring and finding gas because we are buying the Canadian gas, and then that gives them more incentive to drill up there.

Senator **Ford**. I just can't follow it. I have watched one pipeline in reading down through the weekly reports and daily reports where one pipeline has offered to reduce its prices at least twice in the last 6 months. I don't know about you, but——and then we have a State where we have dual pipelines. One is real high in one State and one is lower, and I begin to try to average out what is going to happen under this piece of legislation. The higher price pipeline is buying from itself and finally they mandate to shut a percentage off of everything and we begin to get into the ratable reduction problem a little bit. If you study the situation, there are some discouragements in this bill.

Mr. **Derrick**. Yes.

Senator **Ford**. We had the testimony a few days ago about the pipeline I believe that served Chicago, and they were about 70 percent old gas, 2 percent Canadian gas, the rest in between, and he said if we deregulate old gas, he was devastated, absolutely devastated.

Mr. Lambert, let me ask you a question. You advocate deregulation at the wellhead?

Mr. **Lambert**. Yes, sir.

Senator **Ford**. Should it extend to the pipelines or distribution companies, too?

Mr. **Lambert**. Yes, sir.

Senator **Ford**. And why are you for this bill then?

Mr. **Lambert**. Why am I for this bill? Because I think it is going to enable us to compete on equal terms with any prospective buyer out there. The fact that I have a transmission pipeline in place, I am going to be able to utilize that as a transportation facility and help spread the cost of those users of my facility and help protect the consumers of the State.

Senator **Ford**. But what we are saying to you as a producer is that you are deregulating but then you as a pipeline, regardless of what you pay for it and passthrough that cap—you are intrastate, though, aren't you?

Mr. LAMBERT. We are classified as a local distribution company, yes, sir. We are intrastate. Our business is still regulated by the Public Service Commission of New Mexico.

Senator FORD And you are one of two States that do have a price category? New Mexico and Kansas?

Mr. LAMBERT. Kansas and Oklahoma; we do have an intrastate New Mexico Natural Gas Pricing Act.

Senator FORD. So you really don't care much what happens to the interstate pipeline or the distribution companies outside of New Mexico?

Mr. LAMBERT. No; that is not what I said. In fact I think it would help all of interstates and local distribution companies to have more competition for that commodity rather than having a few in limited areas. I am sure you could find some producers in areas saturated by one pipeline who have had to negotiate contracts that are unfavorable.

Senator FORD. How flexible is a pipeline?

Mr. LAMBERT. How flexible is a pipeline?

Senator FORD. Yes.

Mr. LAMBERT. The pipeline itself has certain physical limitations but they can be operated to provide very flexible operations going by the use of what we call displacement or backhaul exchanges, transportation rates.

Senator FORD. Once a pipeline is in place, it's in place and you can't pick it up and move it some place else to take advantage unless you build another pipeline or trunkline to it?

Mr. LAMBERT. You can modify the way the pipeline operates. You can reverse the flow, for example.

Senator FORD. Is that expensive or inexpensive to do?

Mr. LAMBERT. Some are relatively inexpensive. Others require substantial capital investment.

Senator FORD. The capital recovery provisions, they would increase the transportation cost.

Mr. LAMBERT. Yes.

Senator FORD. Mr. Yates, your statement on page 11, I believe, infers that decontrol of old gas would lessen supply incentives and result in unavoidable and inevitable shortages.

Then do I take it from that, that you oppose decontrol of old gas?

Mr. YATES. No, sir. I do not oppose decontrol of old gas.

Senator FORD. If it creates unavoidable and inevitable shortages, why not?

Mr. YATES. Senator, first of all, I would have to say that in the State of New Mexico there may be other producers who do not support decontrol of old gas, so here certainly I am speaking individually, but I support the decontrol of old gas.

What I am speaking against is the forced abrogation of contracts. What happens when a bill passes which essentially mandates abrogation of contracts is that older supplies of gas are going to be renegotiated not because of some arm's-length requirements of either buyer or seller but simply because of abrogation provision in a bill.

When that happens, that is not the normal process of a free market, and that is simply my argument. If in the process of a free market in my opinion, of old prices, prices of older contracts rise, then that is the market. We will certainly live by that. What we are concerned about is that mandated abrogation would force maximum supplies on a limited market which would naturally cause older prices to rise and lower, and higher prices of newer gas to come down.

Now if that were accomplished in my judgment through the workings of a free market without that abrogation, then we would certainly live by that.

Senator FORD. Is there any incentive to go out and seek new gas? You just said no.

Mr. YATES. Senator, in this bill with the very intricate relationship of the forced abrogation provision, the gas cap and the passthrough limitation, I don't think there is any incentive to go out and look for new gas, and perhaps I should cite a hypothetical example.

If you, for instance, ran a pipeline and 50 percent of your supplies were costing you $1 per thousand, 50 percent of your supplies were costing you $5 per thousand, the dollar supplies are 104 or old price gas. The $5 supplies are a combination of 107-type formation, the regulated gas and other category, you would look at this bill I believe and decide the first thing you should do is protect your low-priced reserves. That is essentially what you own. That is the only way you can amortize that pipeline, so you immediately negotiate with the producer to raise those prices.

Well, let's say that you are capable of negotiating in a relatively short period of time a price of $2.50 per thousand for those gas supplies. Now let's say that the passthrough limitation is at $3 or $3.10 per thousand. That pipeline has no additional resources under that passthrough provision to buy any new gas. Now what happens to that pipeline? If they are suffering from a 20-percent depletion factor per year, obviously the price of newlydiscovered gas, that $5 gas, has to come down, but in addition to that, the price of that new gas is going to be severely retarded.

We maintain that under the interplay, through the interplay of these three very severe control provisions that the likely available price, not through the workings of a free market but through these control provisions, will not stimulate exploration.

Senator FORD. If the committee keeps the contract abrogation provision in S. 615, I assume then that you would oppose its enactment?

Mr. YATES. Yes, sir.

Senator FORD. Last question—your statement discusses increases in middleman cost since the NGPA. The President's bill limits passthrough of gas purchase costs.

Would you support limiting passthrough of middleman cost?

Mr. YATES. Senator, the approach of the Independent Petroleum Association of New Mexico is away from controls and toward market deregulation, and that is deregulation even through the pipeline.

What we advocate is more competition. We advocate the ability of an independent producer to transport gas. We advocate also the ability of a pipeline company to purchase that gas and sell in an unregulated market.

We would in fact support any provisions that would unshackle interstate pipelines, for instance, from requirements that may be onerous and prevent them competing in new marketplaces.

Senator **Ford**. I think we are going to have a very difficult time under this bill going back to the old ways, the old ways of dual system, some being regulated, some not, some being curtailed and others not, intrastates doing whatever basically they want to and interstates limited. We are coming down in my opinion, in a worse situation than we had in 1977 because we did have an economic climate then that was crying out for more gas and a way to get it in the interstate system. We solved both of those—maybe not too good, but we had them out looking for new gas and we had it in the interstate pipeline and there hasn't been a job lost since that bill went into place in a consuming State because of the shortage of natural gas.

We found in Louisville with 23,000 people at General Electric that Lord have mercy, didn't we want to keep them at work, but we had 533 gas we could get in. We had butane or propane or whatever was stored out there and we scratched every way we could to keep those people at work, but after the NGPA went into effect they didn't have that kind of problem. We finally got things in reasonably good shape, and all of a sudden the economy goes kaput, and so the price is coming down. There were some prices going up. It is a very difficult thing for me, and Mr. Derrick makes some excellent points.

You three people are basically intrastate. He is interstate, and everything we have heard this morning so far has been basically intrastate. I am interstate. I have to have the ability to have gas come through that pipeline to serve my people. We make peanut butter, and if you don't have natural gas you don't have the consistency, and who would want to have inconsistent peanut butter?

You know, you may laugh at that, but it's true, so we have to have it. I see Mr. Greer shaking his head. We have to have it, and we've been a pretty good producer of peanut butter. You wouldn't believe that, but it's there. So I have these things to look at, and we have to get away from New Mexico even though you have your peculiar problems, and I have learned some today from your Indian leases and the position you are put in with Federal leases and those sorts of things.

I don't believe you are getting any help in this bill. I know El Paso is not getting any help if this goes through. I think they will be sitting there with take and pay contracts from foreign imports and you are sitting there with a lower cost gas to save the consumer much, much money, and you can't get to it.

Now how are you going to abrogate the contracts? I'll let this producing State fellow work it all out. He is just saying everybody gets it the best you can, but you have interstate contracts that you can't get out of except you do like the pipeline in northern Michigan—just quite taking it and the penalty is a lot less severe than buying the gas, and now they don't have to pay it until 1986 and it goes right back to what Canada says—you are going to be short in 1986. Then you can raise your price and make it go to the consumer anyhow, so I have got a pretty good, as the man said, pretty large problem. I am trying to figure out how to help you all and not hurt us and keep the price down, I believe you have been a prudent pipeline, Mr. Derrick. I believe yours has been a prudent pipeline, and there are several of them out there.

You can have it. I'm going over eat lunch with a distinguished group of people.

Senator NICKLES. I just wonder what peanut butter is going to taste like when it's made out of coal?

Senator FORD. If you will come on with a little research and development, we will have gas and we will have oil and you won't even have to worry about drilling the hole because you can reach out and touch it.

Senator NICKLES. I thank the Senator, and gentlemen, I appreciate your being before this committee. I have some questions and I am hesitant whether or not I would really want to get into them because we also have another panel, and we also have conflicts. The balance of the Senators, we are all having policy meetings which are beginning right now.

Mr. Derrick, you mentioned in your statement two or three modifications you would like to see in the Hodel bill. I think I remember reading or glanced through that that you felt like it was a step in the right direction. Was that correct?

Mr. DERRICK. Yes, sir.

Senator NICKLES. Do you feel if we don't modify or amend the NGPA that we will have—do you feel like this is a step, the Hodel bill is a step in the right direction or possibly we should have NGPA the way it is today?

Mr. DERRICK. I think it is a step in the right direction. I think we need legislation. I would like to see these modifications. Absent these modifications, we will have to reevaluate our position, but certainly I think it is a step in the right direction.

Senator NICKLES. So you feel like there are some inequities and wouldn't you probably agree there is under existing law with the different price categories for gas, 28 different price categories for natural gas, that that has created a lot of—we talk about a dual market, but that has created a lot of different markets and inequities in different regions, customers, et cetera, throughout the country?

Mr. DERRICK. Yes; and of course the ramp under the NGPA where the prices for gas go up irrespective of what the price of other alternative fuels is—the price of oil has been coming down. The price of gas has been going up, so we are now at or above the market clearing price for gas in many areas.

Senator NICKLES. Do you think if we totally deregulated the price of gas that the price of gas would rise or fall?

Mr. DERRICK. It would be most difficult to tell. It would depend on how successful the pipelines or the buyers were in renegotiating downward their higher priced contracts to offset the upward price of the lower price contracts, the old gas.

Senator NICKLES. Do you think ultimately the consumers would benefit by having a lower cost natural gas and a more dependable supply if we moved rapidly toward total deregulation of all gas?

Mr. DERRICK. I think certainly—of course what we are looking at now is deregulation of 102 and certain 103 gas and other vintages of gas in 1985, and we have talked about the price spike and the things that would occur at that time.

In the interim it might be cleaner to stay under NGPA. However, it depends on where the cap is set.

Senator NICKLES. Where do you estimate the cap is?

Mr. DERRICK. I don't know. I have seen estimates between 103 and 102 price which would be probably in the $3 range.

Senator NICKLES. We have also heard witnesses state that they thought the cap would come in in the neighborhood of 225 or 250, depending on the volume and number of 104 contracts that are renegotiated, so anyway, you do favor abrogation of the contracts, of the take or pays, and the more favored nations and so on?

Mr. DERRICK. Yes; given the modifications we have suggested, we would support the Senate bill 615.

Senator NICKLES. You wanted to go a little bit further and also abrogate contracts between pipelines?

Mr. DERRICK. I would want FERC or an appropriate agency to take a look at that. I don't think every pipeline and every distributor or contract should be reduced, but I think there should be a thorough search made to see if it is in the best interests of consumers now under the present arrangement.

Senator NICKLES. You had a couple of addendums in your statement that talk about additional legislation. Did you touch on that?

Mr. DERRICK. Basically I was touching there on the first sale, Another thing I would like to see in the Senate bill 615 is right of first refusal by the buyer, and that is not in there.

Senator NICKLES. When you talked about the dual market I guess you mentioned or implied the fact that while interstates were under the passthrough limitations, intras were not.

Do you think intras should be under the passthrough limitation?

Mr. DERRICK. Well, that would make it more competitive I believe. It would give the interstates a better competitive position as far as the purchase of gas.

Senator NICKLES. Don't the interstates, as I understand your statement, presently don't the interstates have a competitive advantage over the intrastates?

Mr. DERRICK. I think they probably do as to the cushion gas, the old gas, that probably some of the intrastates do not have.

Senator NICKLES. I make that point so in effect there is almost a dual market that is existing today?

Mr. DERRICK. Well, no one is suffering today due to lack of supply, and I think that is where it would become evident, when we reach the point as we were in the mid-1970's where the pipelines were not able to acquire the gas they needed to supply their requirements and we had a situation where the interstates were not competitive.

Senator NICKLES. OK. We have a dual market if you have the cushion, but if it is reversed it may not be quite so good?

Mr. DERRICK. I guess what I am saying is the dual market is not a problem as long as there is a glut or a bubble of gas.

Senator NICKLES. What about the bubble you mentioned? Specifically I think in your statement you were talking about not being able to sell gas in California and the fact that they were importing either Canadian or Mexican gas in the $4, $5, $6 range. There is an inequity that is posed by this.

Do you favor bringing those contracts either—should we have an abrogation of those contracts?

Mr. DERRICK. I would like to see it very much.

Senator NICKLES. Does El Paso—don't I remember reading something about your being actively involved in a large LNG project?

Mr. DERRICK. We are out of that. We have been for several years.

Senator NICKLES. You were negotiating. I realize it didn't work, but weren't you in the process of negotiating a large LNG contract?

Mr. DERRICK. Starting in the late 1960's, we entered into an agreement with Algeria to furnish LNG.

Senator NICKLES. That is kind of in the back of my mind.

Mr. DERRICK. That was, of course, at the time when the gas shortage was developing and it continued, the shortage continued through the 1970's or at least in the early to mid-1970's.

Senator NICKLES. If you had made that extensive amount of investment in the tankers and the processing and refrigeration——

Mr. DERRICK. We made the expenditure. We had nine tankers. We were bringing gas in until the Algerians raised the price, so we went through the whole cycle.

Senator NICKLES. I guess I was going to turn that around. If you had a price—you know, a lot of us, I personally am one that has been complaining when I see this $7 figure and the 494 figures for imported gas; 714, I think, is what I saw for the LNG, thinking those are very extremely high prices when we are sitting on gas that we can't sell that is low-cost gas, but conversely, if you had that contract, if El Paso had that contract, you had that same position, would you have abrogated that position?

Mr. DERRICK. Well, at the time we entered into the contract, of course, it was during a period of gas shortage. I think you would have to permit a buyer or a pipeline to bring in gas that is planted. For example, coal gasification; if a buyer or a pipeline gets a certificate to build a coal gasification plant or to bring in LNG, I think that should be honored because at the time he made the investment it appeared that the gas was needed, and there is such a long delay in regulatory lag and other lags that it takes a while, maybe 6 or 8 years, to get a project underway.

Senator NICKLES. Do you favor then keeping the price on the old gas so you can average in those market mistakes on that higher end?

Mr. DERRICK. No. In our support of Senate bill 615 it does not contemplate holding down the price of old gas.

Senator NICKLES. You do favor deregulating old gas?

Mr. DERRICK. Yes, sir.

Senator NICKLES. Do you have any suggestions on how we might approach the—again, I have a hard time abrogating any contract, foreign or domestic. Conversely, I guess I would repeat I don't like seeing the fact that we are shut in domestic production and bringing in expensive imports, particularly when we see and find that those imports have a great amount of subsidy for the Government. I can't recall the figure. We looked it up. It wasn't Canadian—494—but the Canadian Government is getting a large percentage of that. I can't quote it, so I won't.

Mr. **Derrick**. It doesn't all go to the producer.

Senator **Nickles**. The producer was in the $1.50 range by the time you put on $1 for transportation and I think there was something like $1.60 or something like that in tax, and maybe more than that. There was a fee, different fees and taxes, but it was, a very, very substantial portion of that was going to the Canadian Government.

The same thing was going for the gas that was mined from the Mexican Government. We are greatly subsidizing their governments at the same time we are not buying gas from domestic producers on this side of the border, and dealing with El Paso, you are very close to that border so when you have gas that is shut in and domestic production is shut in at the time we are sending dollars by the billions out to other countries to subsidize their governments, that causes me a real problem.

Do you have any suggestions?

Mr. **Derrick**. No, I don't believe I do.

Senator **Nickles**. We are going to look at that, but you do feel, and I might ask some of our other panelists, is it your consensus that if we are going to have a gas cap on domestic production—I think it is important, too, to make the record clear that some have indicated there is no controls or limitations on producers.

Mr. Yates, do you want to touch on that just real briefly without repeating your whole statement?

Mr. **Yates**. Senator, it is a very difficult thing, as you have stated, to address foreign imports. However, it seems the independent producers by and large, feel that if foreign imports are not going to have a price cap then certainly the domestic natural gas sales should not have a price cap.

We seem to again be slipping into a position where there is almost a reverse tariff on domestic production. It is not an equitable producing environment.

Senator **Nickles**. You are saying yes, we will not control in the foreign but we will control in the domestic, that inhibits domestic and encourages foreign?

Mr. **Yates**. Precisely.

Senator **Nickles**. I agree with that wholeheartedly. Would you agree with that, Mr. Derrick?

Mr. **Derrick**. Yes.

Senator **Nickles**. Mr. Derrick, a followup question—if Canadian contracts or Mexican contracts for imports were under the same provisions or limitations, the passthrough provisions, under the same provisions, gas cap provisions, et cetera, how much money could El Paso save for the California consumer?

Mr. **Derrick**. We did a study based on what our prices are and what the Canadian gas delivered to California is. It ran about $250 million a year.

Now if those prices were adjusted downward—is that what you are suggesting, that Canadian come down? They might come down below our price, if they came down to $1.25 or so.

Senator **Nickles**. Am I correct, though, as far as the passthrough limitations in your adjusted cost that you are able to passthrough, that includes, does it not, the current volume of gas that the price would include, the import?

Mr. DERRICK. Yes. I understand. That is correct.

Senator NICKLES. If, for instance, El Paso or Northwest or whoever is buying the Canadian gas, if they have that 494 figure, then they have that where they can work off, so they have already got that?

Mr. DERRICK. That would be grandfathered I believe.

Senator NICKLES. That would already be in their schedule? They would have some room or some cushion if they wanted to be able to move forward from there?

Mr. DERRICK. Yes. They would be able to pay more or they would be able to pay the cap if they were above the cap whereas El Paso may be below the cap.

Senator NICKLES. And Mr. Lambert, Mr. Greer, real quickly, again it has been somewhat stated that we have limitations on the pipelines under passthrough.

Could you state again are there limitations that would inhibit production in this bill or limitations on producers that you might just touch on?

Mr. YATES. The limitation on producers is going to be a price constraint.

Senator NICKLES. Gas cap?

Mr. YATES. A combination of a gas cap with the abrogation provision, with the gas adjustment provision; if that gas adjustment provision is exceeded, then, of course, it requires a FERC decision to allow a gas pipeline to pass through costs to through customers.

Senator NICKLES. Isn't your biggest concern the gas cap?

Mr. YATES. My biggest concern is the combination of the abrogation provision and the passthrough provision. Frankly, if I could elaborate a bit, what we see in the oilfield today is a volume limited constraint on drilling for new supplies.

The reason for that is the gas wells are shut in. New gas wells being drilled are not being connected. It is not necessarily a price inhibition. If this bill passes with this provision, contract abrogation provision, gas cap and passthrough provision as it is written, we will have even in a rising market, we will have a price constrained inhibition on new drilling and they are two very different things. The volume restrained inhibition on drilling can be cured with a reviving economy and it can be cured fairly rapidly.

A price constrained limitation on drilling will not be cured so rapidly. Then we are back to the early 1970's where price controls are inhibiting the drilling of gas.

Senator NICKLES. Thank you. I appreciate your coming, and gentlemen, I apologize for the fact that more Senators aren't here and that your statements will be, of course, put in the record and I have additional questions that I want to ask but we do have another panel, and I also have a 12:30 lunch and meeting that is kind of important, so it is going to be necessary for me to—Mr. Lambert, do you have a quick comment?

Mr. LAMBERT. Senator Nickles, I did want to make a comment as to our position. We are not in favor of the passthrough limitations either on the interstates nor intrastates. Even if they are prudent acquisitions and they are only allowed to flow through a portion of that and it is determined at a later time to be prudent, then that company has incurred the cash outlay and the expense of financing that cash outlay. The consumer will ultimately be burdened with it at a higher cost than he would otherwise have been, and perhaps not even the same customers would receive that burden who actually cause the incurrence of that penalty, so I want to make it clear that our company is not in favor of the limitations.

Senator NICKLES. Thank you very much. Mr. Greer, thank you, too, for your statement. They are well received. Gentlemen, thank you very much.

Our next and final panel that we have is Mr. William Fisher, who is director of the bureau of economic geology, University of Texas, and then—I didn't know we allowed Texas before an Oklahoma Senator. And also we have Mr. Henry Schuler who is director of energy programs, center for strategic and international studies, Georgetown University.

Mr. Schuler, Mr. Fisher, welcome; your statements will be entered into the record in full. I would appreciate very much if you might just make a few comments in regard to possibly some of the previous statements that have been made on the bill, but your statements will be entered into the record so if you could kind of touch a few highlights, I would appreciate it.

STATEMENT OF WILLIAM L. FISHER, DIRECTOR, BUREAU OF ECONOMIC GEOLOGY AND DAVIS PROFESSOR OF PETROLEUM GEOLOGY, UNIVERSITY OF TEXAS

Mr. FISHER. Thank you, Senator Nickles. I am William L. Fisher, as you have indicated. I am pleased to be here today to make some observations. I will be quite brief in view of the hour.

We face, I think nearly all will admit, a very complicated and inequitable natural gas system at the present time. Legislation most would agree in some form or another is in order for a reformation and modification of that system.

I think what is the principal thrust of S. 615 is that it aims to move gas to an ordered and efficient market and to do it over a phased period of time. This point has been to some extent lost here because of the restrictions that are put on in passthrough, put on in the price cap and the other kind of provisions are only for a period of transition to move to that, as in fact decontrol or deregulation of the old gas is also only for a transition until it reaches that point, so these are important stabilizing elements I think in the moving to an ordered market.

I think it is absolutely essential that we do that for the reason that is the only kind of procedure where we can have a system that we can truly say it is fair and equitable to everyone. It is the only kind of system we can have that can give us the efficient resource development where we are developing the best gas at the right time and at the most prudent cost and price. It permits efficiency in allocation and use, and it allows gas to ultimately compete on an equal footing with other kinds of fuels, and all of these kinds of things I think are very basic and important to us.

It is absolutely essential that there be an elimination of wellhead controls. I think doing them over a phased period as will be the case here under Senate bill 615 is a very prudent way to go. Without any question the existence particularly of 104 gas at its relatively low price I think has been the main culprit in the disordering and creating the wide range and disparity of prices, the inequities and so on that exist, and the fact that this cushion of 104 is held on a disproportionate basis simply enlarges that anomaly that we have got, and I don't think there would be any objection toward reordering that very tough issue of getting that section of gas, as all other gas, off of wellhead price controls.

I think that should be coupled with the very important stabilizing provisions that are put into the bill, and it wisely recognizes that we can't move to that ordering overnight. It is going to take some time, and we need to stabilize it. The gas cap is one method. The PGA is another, all of which have been discussed here extensively. I think these are critical. We may need some slight modification on just exactly how we calculate a gas cap, given the fact that we are moving into a transition with a very thin margin of natural gas initially. We need to determine that. One could do it simply on new gas. That would be perhaps meritorious except you would have an exceedingly thin margin for several months. You could include the renegotiated contracts as the bill provides. That will run some risk of introducing some anomalies very early on because we simply don't know the timing and the volume and particular kinds of contracts and schedules that have come up for renegotiation, so it may be worthwhile for the committee to look, to ask even the department to look somewhat further to some kind of stabilizing factors within that.

You could look at such things as including, in addition to weighted controls of new gas, mobile prices will be another kind of modification. You could even look at some sort of weighted or presumed market-clearing price and let that progressively decline in its way. I am not making specific things, but something that would give some degree of stability in the determination of the cap through this transition so that we don't have wide swings up and down, and that would add tremendous distortions that probably would not be necessary in this kind of a transitional period.

I think the proposed limitations on PGA cost passthroughs are necessary. They are designed to put downward pressure on price bidding, that is, or is presumed to be above market-clearing levels.

That imposition is going to create some problems I'm sure, but it is an essential ordering mechanism that I think is wisely included in the bill.

There are lots of concerns on the reduction of take-or-pay requirements, even as to the constitutionality of it. Again, I think generically that kind of measure is important in the transition.

There is a possible alternative to legislative abrogation of contracts in looking very carefully at the utilization of take orders by the various State regulatory commissions. That has worked fairly effectively in my State. That is a possible alternative to contract abrogation by legislative action.

I will make a couple of final comments here on future prices and future gas supplies. We don't know for certain what price path we are going to have on natural gas. There is a lot of assumption around, a lot of projections made. Those depend upon the assumptions that are made. Our experience in projecting forward cost is that it has not been all that good in the last decade, and that is enough to sober anyone I think, but there are a few obvious things.

We are proposing to make this transition in a time when there is a surplus of gas and that will work to the benefit of stabilizing I think without any question. Over the long term, I think we simply have to appreciate that gas prices will move in equilibrium with competitive fuels and that is a long-term balancing act that works. I don't think we are in forever for increasing gas prices.

Gas does compete. I will cite briefly the example in my own State, and I know this is going on very strongly in your State as well, and that is the conversion to coal and lignite which has occurred very dramatically. We are now facing in Texas the equivalent in coal or lignite of a trillion cubic feet of gas a year, and that is 20 times more than it was a decade ago, so as those gas prices rode on the intrastate back in the 1970's, there was in fact competition of natural gas in the utility and in the industrial sector for coal, so in fact it does work.

Well, I think if there provisions of Senate bill 615 are enacted there is going to be some reordering in the exploration and drilling area. That has been a concern that has been expressed here this morning. That will temporarily impact at least on drilling and exploration, and probably some cost in near-term supply. It is going to particularly impact the independents who have sought price incentive gas under NGPA, yet that is another one of the things, one of the kinds of costs I think that we will simply have to inevitably bear as we move through a transition to get to the ultimate goal which is fair and effective ordering of the market and getting to decontrol of the market. It will call for not an elimination of drilling. It will call for a restructuring of that drilling effort and historically drilling efforts go on so there is some cost that will be offset to a certain extent by the surplus that exists.

I think there is no way out of our current natural gas problem that is without pain, particularly in the transition to an ordered market, but I think this pain that we concern ourselves with, we should keep in mind that very much of it is of a temporary nature, of a 2- or 3-year period that we move to a situation that is going to be in my judgment our best assurance of adequate supply and reasonable, fair price. I think that natural gas is simply too important in this Nation's well-being for it to be treated any other way than to get it into operating with the economic efficiencies of the market. There will be refinements in the specifics of this bill. It is a good starting point. I think it really is essential that its basic principles be kept in tact, and if they are, I think it offers a rational and fair way out of the complexity and irregularity of the market that we have now.

Thank you, Senator.

[The prepared statement of Mr. Fisher follows:]

Statement of
William L. Fisher, Director, Bureau of Economic Geology
and Davis Professor of Petroleum Geology
The University of Texas at Austin
Before The
U.S. Senate Committee on Energy and Natural Resources
March 22, 1983

Mr. Chairman and Members of the Committee:

I am William L. Fisher, Director of the Bureau of Economic Geology, and Davis Professor of Petroleum Geology at The University of Texas at Austin. I am pleased to be here today to make some observations on natural gas legislation, and specifically S.615 as proposed by Secretary Hodel and the Administration and as introduced by the Chairman. I appear on my own behalf and represent no one. I do reside in a State that is a major producer of natural gas and a State that also consumes nearly as much natural gas as the next three leading states combined.

We have in this country, in natural gas, a critical and significant energy source. It is an efficient, clean fuel which on the average is relatively inexpensive compared to alternate fuels. Further, natural gas, both conventional and nonconventional, is still a relatively abundant resource, and if aggressively and effectively explored for and developed, can continue to be a major portion of this Nation's domestic energy supply for many years to come.

On the other hand, natural gas is explored for, developed, transmitted, distributed, and consumed within one of the most complex and disparate markets conceivable. Certainly some of that complexity is inherent in the nature of the commodity, and its transportation and utilization, but an inordinate amount of the market complexity and disparity stems from nearly three decades of regulation, and further regulation too commonly applied in a discriminatory manner.

The Congress passed the NGPA in 1978, seeking to overcome certain of the perceived disparities of the dual market system then existing. Certain of the objectives of the NGPA, both those productive and counter productive, have been achieved. That Act, partly but not entirely due to events that have occurred since its passage, has greatly enlarged the complexity of the natural gas market, has served to disorder the market further, and has created a wide range of relative advantage and disadvantage to several segments of the system. I shall not review these for they are well known to this committee. The prevalent view, which I share, is that natural gas policy and legislation is in serious need of reform and modification, not only because of certain flaws of the Act, but also because of significantly changed events. Obviously views as to what needs to be modified and how differ considerably.

In my judgment, S.615 embraces the kind of policy and provisions that will start the processing of ordering and making more efficient this important and critical market. It does so with an appropriate sense of equity and fairness. It wisely seeks to order the market by gradually and progressively subjecting natural gas production and consumption to market forces with a date certain for full market operation.

But critically it also provides several very stringent procedures for consumer protection until such time as the market is ordered and working fairly for all. Its laudable goal is to move to a system that will provide over both the short and the long term, adequate supplies at reasonable, fair, and competitive prices. If its basic principles are held intact and if some of its specific provisions are further matured, its goal can likely be achieved. There are several proposals before this Congress. Several seek to enlarge, maintain, or create relative advantage for certain, generally specific segments of the natural gas production, transmission, and consuming system; but specific advantage must be gained at the inordinate expense of others. The principle of equity and equal footing for all, I believe embraced in S.615, must guide the Congress in action it must take.

Let me make a few observations on the specific provisions of S.615.

Elimination of wellhead price controls: S.615 wisely provides for the eventual elimination of price controls at the wellhead for all categories of gas. Such elimination is appropriately phased through the provisions of incentives for contract renegotiation and for market pricing of new gas, but to be accomplished on a certain date. While some will vigorously oppose the price decontrol of old gas this provision is imperative to any hope of ordering the natural gas market. The control of Section 104 gas at low prices has been, without question in my judgment, the main culprit in the extensive disordering of the market. The existence of cheap cushion gas is a major anomaly; that it is held on a disproportionate basis enlarges the anomaly. If the cushion is allowed to remain it will continue to disorder market until its eventual depletion several years into the future. Its elimination will create some temporary problems for certain producers, pipeliners, and consumers alike, but a fair and balanced market without wide extremes in prices is impossible with Sec 104 controls in place. Fortunately a temporary excess of gas supply exists, unfortunately brought on by reduced economic activity and reduced demand. The existence of excess supply, though likely temporal, offers the best timing for the beginning of price control elimination.

Stabilizing provisions with transition: S.615 wisely and fairly provides for a number of procedures designed to stabilize the transition toward ordering of the complex and disparate natural gas market. As well, provisions are designed to pass on to consumers some of the benefits attendant to excess supply. These include the gas price cap, limitation on pass through of purchased gas adjustment costs, and a reduction in purchasers take-or-pay requirements. In my judgment, it is critical that procedures of such generic make up as these be in place in the transition, although the specific composition of these provisions may need further refinement.

Most critical is calculation of the gas cap which is supposed to be a reflection of the current market clearing price. Unfortunately no one knows, nor is there any precise way to determine market clearing price, given the wide range of price categories now in place. The cap, of necessity in a phased program, must be initially based on a thin, and what might well be in the anomalous market existing today, a most volatile margin. Basing the cap on first sales of new, decontrolled gas alone has merit, but such would be a very thin margin for at least six months. Inclusion of the weighted-volume average purchase price in renegotiated contracts, as proposed in S.615, widens the margin considerably, but runs the risk of introducing some significant anomalies in the calculation, at least in the early stages, even utilizing the three-month moving average. It is difficult to predict the kind, volume, and timing of contracts that will be renegotiated. While one hesitates to make the price cap calculation more cumbersome, additions that would give a more stable cap are critical if the potential risk of wild price swings is to be avoided. Modification of the formula by adding a calculated modal price, i.e., the most frequently quoted price, is a possibility. Another might be to modify the proposed formula by weighing in at a progressively declining rate, an agreed-upon, albeit arbitrary, presumed market clearing price. Tying the gas cap to average price of competitive fuels is a possibility, but a tie to fuel oil, for example, might introduce even more volatility. Coal, while a clear, longer term competitive fuel, seems inappropriate as a short-term transitional tie. I am not prepared to offer specifics at this time, but do believe it important to consider further the calculations of the price cap in such a way as to minimize disproportionate upward or downward pressures on the cap until such time as the margin gets widened.

The proposed limitation of PGA cost pass throughs is designed to put doward pressure on price bidding that is or is presumed to be above market clearing levels. Imposition of the limitation may create some transitional problems, but it is an important consumer protection element in the bill. While the mechanism might be refined, it seems to me more easily addressable than the price cap determinations.

What the proposed reduction in take-or-pay requirements is designed to accomplish is important in the transition. A possible alternative to legislative abrogation of contracts could be utilization of ratable take orders of state regulatory authorities.

Again, I believe that provisions of the type proposed by S.615 are in keeping with vital principles of equity and fairness. Determination of these in a manner that is stabilizing rather than destabilizing is important.

Other provisions: Repeal of end-use restriction on the consumption of natural gas, as called for in S.615, is appropriate and necessary. The provisions for equal access to supply by all segments of the market are essential to balancing and ordering the market and are, further, totally consistent with equity and fairness.

Future prices and supply: I shall conclude with a few observations on future gas prices and future gas supplies.

No one know for certain the future price path of natural gas. Assumptions of varying degrees of validity can be made to show varying price paths. While our experiences in projecting forward prices of energy are such as to sober anyone, there are certain factors that give us some logical clues. The presence of excess supply at the moment, along with the proposed price restraint provisions in S.615 strongly suggest that average prices of natural gas will decline over the short term. There is little to indicate any average price decline if NGPA is left unaltered. Over the longer term average gas prices will rise to equilibrium with competitive fuels. At what level they move will depend on price levels of alternative fuels and provisions of S.615. In the later 1980's, average prices under provisions of S.165 will likely approximate average prices under a continued NGPA. But critically, in an ordered market average price will have meaning and the disparate extremes of NGPA will not exist. We are certainly not in for ever-increasing gas prices. Gas must compete with other fuel sources, including oil and especially coal. The record in my own State over the past decade in the movement to coal and lignite as gas prices rose is instructive. Utilities in Texas now consume roughly the coal and lignite equivalent of 1 TCF of gas, 20 times the level in 1972. Of all the additional coal consumed in the Nation since 1973, 30 percent has been consumed in Texas. And while average gas price in Texas in 1976 was 125 percent of the national average, it is now 85 percent of the national average.

If the provisions of S.615 are enacted there will be some reordering of the exploration and drilling effort now in place. That reordering, along with anticipated average price decline in the face of excess supply will, at least temporarily, impact drilling and exploration at some cost to near term supply. Mr. Murray presented to this Committee in earlier hearings the strong dependence of supply on active drilling levels, and the evidence he showed is firm in my judgment. The reordering of current exploration effort will particularly impact independent operators who have directed much of their effort toward incentive-priced gas under NGPA.

The transitional impact on drilling and its impact on supply will be offset, at least temporarily, by the current surplus of gas supply.

In short there is no way out of our current natural gas problem that is without pain, particularly in the transition to an ordered market. However, an ordered market will lead to the most efficient resource development and the best assurance of adequate supply at reasonable, fair prices. Natural gas is too important to this Nation's well being to be treated any other way. While there will be refinements in specifics, S.615 is a good starting point and if its basic principles are enacted, it offers a rational and fair way out of the complexities and inequities of our present natural gas system.

Senator NICKLES. Thank you very much, Mr Fisher.

Mr. Schuler?

STATEMENT OF G. HENRY M. SCHULER, DIRECTOR, ENERGY PROGRAMS, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Mr. SCHULER. Thank you, Senator. My name is Henry Schuler. I own the Drew F. Bartlett Chair of Energy and National Security and direct the energy program at Georgetown University, the Center for Strategic and International Studies.

I think it is perhaps appropriate that I am the last witness today and perhaps in these series because I hope that at the end of the day after the Senate has considered all of the difficult questions and details such as the peanut butter industry in Lexington, Ky., that Senator Ford referred to, I hope that after all of those are considered the Congress will return to the overriding concern which is in fact this country's energy security because the country's energy security lies at the very heart of our military preparedness, our diplomatic flexibility, our alliance relationships, the international financial stability, and all of those things that we link, lump together under the rubrick of national security, and I am convinced that our concerns about the Nation's energy security are as real today as they were at any time in the past.

We hear that oil prices are going down, yet last year this country still imported one-third of its total oil requirements at a cost of $60 billion. Perhaps that will fall to $50 billion if we don't increase the volume this year, but I don't consider that a significant reduction in vulnerability.

We are told that oil is coming from more secure suppliers and yet if you look at the statistics, half of the oil that is moving in world trade, and I emphasize moving in world trade, not consumption, but half of the oil available for trade, comes from the Middle East. If you add the Arab countries outside of the Middle East such as Libya, Algeria, Tunisia, and Egypt, you raise that to two-thirds of oil moving in world trade. If you then add predominantly

Moslim countries such as Nigeria, Indonesia, and Malaysia, you raise it to 80 percent of the oil moving in world trade is from countries that have concerns about the kind of political problems that have produced embargoes and supply interruptions and price escalations in the past, so our energy vulnerability remains, and I am convinced that natural gas provides for this country the most attractive alternative to those oil imports.

Yes, there are a lot of problems. We have heard a lot about the problems of natural gas utilization this morning in these hearings and in the other hearings that you had, but I think you will agree that they paled by comparison to some of the other fuel alternatives that we have in this country.

The nuclear power industry, that is totally stymied by what many people see as far greater risk than the risks discussed this morning which is threatened by scientific concerns about acid rain and the greenhouse effect and all sorts of things.

The undeveloped potential for nuclear fusion, for solar electricity, all of which depend upon technological problems that make the problems discussed this morning pale by comparison—synthetic fuels, which simply can't compete; now if you want to rule out all of those and then rule out natural gas as well, you end up with a situation where this country is very vulnerable and I would suggest that in considering natural gas policy we might do well to consider some of the approaches taken by our allies and our adversaries alike toward natural gas production and utilization.

I recognize that this is a rather unusual suggestion because the United States is in fact the largest producer and consumer of natural gas in the world. We have only limited volumes of imports and they are from relatively secure Western Hemisphere suppliers, but I would respectfully submit that that is precisely the argument that prevailed in the 1950's and 1960's with respect to oil. We could then claim to be the largest producer and consumer of oil, not at all dependent upon imports except for Western Hemisphere suppliers, and what did that get us? It got us into regulatory policies and tax policies which produced by the 1970's a decline in energy, oil exploration in this country, a subsidization of oil imports and led to the cartelization and politicization of the international oil supplies which burdens that we are still bearing, and I suggested that we look at these, what some of the other countries around the world are doing and the thrust of my testimony that I have submitted deals with that and CSIC is today holding a conference that I left to come up here that deals with the strategic considerations in other countries' gas decisionmaking.

I would mention just three or four of them very quickly in passing. One is the consideration that was a driving factor in the 1978 legislation which was, and I would quote, "* * * that gas is simply too valuable to be used as boiler fuel." Now I think if you look at what other countries are doing, our allies in Japan have vastly increased their gas utilization, and they currently import 3 billion cubic feet a day of very expensive LNG, far more expensive than our gas, and they use 75 percent of that for electric generation, something that is discouraged in this country.

They are intending to increase the amount of gas that they use in electric generation so that a percentage of 15 percent in 1980 of total fuel supply used in electric generation will rise to 20 percent in 1985.

They intend to trim their LNG imports. Turning from our allies to our adversaries, we find the Soviet Union intends to back out some two-thirds of the oil consumption that is currently consumed in the U.S. area or in the Soviet Union for steam and electric generation. They intend to back that out with natural gas. The much-discussed pipeline from the Usafield to Western Europe is but one of six lines that the Soviet Union is building from that field.

The other five are all committed to domestic utilization, so they are expanding their production and utilizing it for boiler fuel.

Another argument that one hears with respect to natural gas is well, it will never solve our transportation problems. It is only useful in stationary sources. Perhaps that is true at current prices of oil, but I think we have got to recognize that the Government of New Zealand is investing $1½ billion to turn natural gas which it has in abundance and it doesn't have oil, so it is turning its abundant natural gas into methane and methane into gasoline in an integrated process that by 1987 will meet 40 to 50 percent of New Zealand's motor fuel requirement.

The East Germans are doing the same thing—turning natural gas into compressed natural gas to run vehicles. The Italians are doing it. The Soviets are doing it, and we are arguing that gas has no utilization except in stationary sources.

There have been references made to the price of Canadian and Mexican gas imports. I would only suggest that those prices are going to rise because not only is it a question of what the market will bear, but the cost of those supplies are going to increase because 60 percent of Canada's reserves and potential resources are in the so-called frontier regions like the Atlantic offshore and north of the Arctic Circle. Those are going to be as costly as Alaskan gas which we all know is not coming on the market now because of concerns about the cost.

The Mexicans have other alternatives to use their gas and they will almost certainly use their gas to back out their internal economy, in order to export oil so that they don't have to burn their own oil because they have greater flexibility and can make more money on oil, so I don't think we should count on them or low-priced natural gas from Canada or Mexico.

Finally, just one last word on the question of gas pricing—I came as I say from the conference this morning where I managed to hear the first speaker who discussed European gas, and the EEC has expressly adopted a policy which calls for consumers, all consumers to pay the market price for natural gas, and in fact the gas is to be priced at its replacement cost value, so we seem to be the only people in the world who think that we can interfere in the marketplace in that respect and not produce either shortages or the kind of distortions that have come around to bite consumers as a result of the Natural Gas Policy Act, so, in conclusion, I would say I fully support the efforts of this administration to move toward decontrol of natural gas by a date certain.

[The prepared statement of Mr. Schuler follows.]

Testimony submitted by
G. HENRY M. SCHULER
Director, Energy Programs
CSIS/Georgetown University

Like the occasional debates over U.S. oil policy in the 1950s and 1960s, the debates over natural gas policy in the 1970s and 1980s have been largely oblivious to gas developments elsewhere around the world. It is hardly surprising that U.S. policy-makers should view themsevles as beyond benefitting from the experience of other countries. After all, we still lead the world in gas production and consumption, just as we led the world in oil production and consumption during that earlier period. Similarly, natural gas imports now meet about the same small portion of total demand that oil once did, and in both instances the imports have come largely from politically secure Western Hemisphere suppliers.

Unfortunately, that earlier complacency about oil led in the 1970s to regulatory and tax policies which discouraged domestic exploration activity, effectively subsidized rapidly expanding oil imports and thereby promoted the cartelization and politicization of world oil in a manner which left the country dangerously vulnerable to supply interruptions and price escalations. In the early 1980s that situation has been ameliorated by the efforts of countries around the world to expand their own oil production and to substitute other energy sources, especially natural gas, for imported oil.

The United States has done its part to expand domestic oil production by removing federal price controls, but its efforts to substitute domestic natural gas for imported oil have continued to suffer from federal intervention in both its production and utilization. Since we cannot assume that our vulnerability to international oil developments has been eliminated for the present, let alone for the future, we must reassess our natural gas policy in a strategic and international context to determine whether we can increase its production and substitution for oil.

One way to do this is to compare our efforts against those of other countries around the world. To this end, CSIS has convened a workshop for Congressional and Administration policy-makers to meet with gas experts from government, industry and academia around the world. Attachment I lists those experts and their subjects. By coincidence, that meeting is taking place the same day as these hearings, but I have been able to benefit from papers which our experts prepared in advance. Therefore, I am pleased to cover a few highlights and would welcome an opportunity to meet with interested Senators and staff for more detailed discussion after reviewing the full record of the workshop.

If I could summarize those papers at the outset, they make it clear that since the first oil shock of 1973 virtually all countries have been making a greater effort than the U.S. to increase the substitution of natural gas for oil. Interestingly, this seems to be true of our adversaries as well as our allies, of countries which must import gas as well as by countries which have domestic gas resources and by free market economies as well as centrally-planned economies. This becomes clear when we examine their very different responses to concerns and attitudes that impede U.S. production and consumption.

Utilization of Natural Gas for Boiler Fuel

The Natural Gas Policy Act of 1978 and its companion legislation, the Fuel Use Act, proceeded from the assumption that natural gas is "too valuable" to be used as boiler fuel by industry or utilities. Therefore, Congress barred certain gas usage through outright prohibition and discouragedotherusage through discriminatory pricing. The result has been a reduction in industrial demand which has burdened residential users with higher transmission and distribution costs, thereby threatening the reimpositon of price controls which would further reduce the incentive to expand gas exploration and production.

Other governments do not suffer under the delusion that they can -- or must -- substitute their own scale or social values for economic efficiencies in allocating gas supplies.

- Japan, for example, burns 75% of the over 3 billion MCF per day of high cost LNG which it currently imports for the generation of electrical power. This utility usage is scheduled to grow as Japan increases LNG imports by about one-third in order to expand LNG's share of total electric power fuel from 15% in 1981 to 20% in 1985. Beyond 1985, the Japanese government has set a target of tripling LNG imports by 1990. The history of Japanese gas policy which led to this increasing utility utlization is instructive. It began in 1969 when Tokyo Electric Power Company, the world's largest privately owned utility, decided to import Alaskan LNG because clean-burning gas was the perfect solution to growing air pollution. Seeking to diversify fuel sources after the 1973 oil shock, the Japanese government decided that gas provided strategic as well as environmental benefits. Accordingly it adopted a policy to expand gas utlization by:

-- Developing a political consensus on the desirablility of diversifying energy supplies and encouraging the use of fuels other than oil;

-- Setting an ambitious target to reduce the role of oil to 50% of energy demand by 1990.

-- Providing an implied guarantee to commercial firms and their bankers that the targets would remain consistent and not be subject to passing political whims; and

-- Assisting industries through low interest government loans, tax relief for specified investments and government guarantees.

As a result of these efforts, the role of gas in total energy demand has risen from a fraction of 1% in 1970, to 5% in 1980 and will meet over 10% in 1990. Japan must pay very high prices for these LNG imports and would obviously assign an even greater role to gas if it were blessed with domestic resources like those in the U.S.

o The Soviet Union is another example of a country which is rapidly expanding its utlizat[illegible] gas as boiler fuel. In fa[illegible]bitious plans to displace two-thirds of total oil demand currently used for electricity and steam generation by retrofitting exisitng facilities and building all new installations to burn gas. The massive Soviet gas program is especially interesting because it represents Moscow's response to problems very similar to those faced by Washington -- stagnant oil production, unmet coal targets, postponed growth in nuclear power and technolgocial problems with long distance electricity transmission. Although it is impossible to assess the cost of Soviet gas on a basis comparable to that in a market economy, several statistics provide an indicator of the price which the Soviets are willing to pay in order to raise gas' share of total energy mix from 27% in 1980 to 35% in 1985:

-- Some $26 billion is being invested in gas development during the 11th Five Year Plan (1981-85) at a time when investment in equally pressing areas such as food processing, construction materials, ferrous metallurgy and machine-building have to be "short-changed."

-- Two-thirds of Soviet natural gas reserves (1.235 quadrillion cubic feet) lie north of the Arctic Circle and are very costly to develop

-- The Urengnoi gas field, already the world's largest producer, is slated to expand from 1.77 tcf in 1980 to 9.07 tcf in 1985 by constructing some 12,00 miles of 56 inch diameter pipeline (the hotly debated line to Western Europe is just 1 of 6 new lines with the other 5 committed to domestic consumption), installing at least 160 compressor stations, drilling over 1,000 wells, building 15 gas-processing plants and expanding gas storage facilities for peak winter demand.

As a result of these investments, natural gas will account for almost 65% of the total growth in energy during the current Five Year Plan and by the later 1980s the USSR will be exporting up to 3.53 tcf per year with half that stream earning some $8 billion in hard currency from Western Europe (estimated average price of $4.70/mcf).

Utlization of Natural Gas as a Transportation Fuel

Even those American analysts who accept the use of natural gas as boiler fuel will sometimes argue that the role of natural gas substitution is limited to stationery such uses because it cannot be used as a transportation fuel. This tends to minimize efforts to expand gas supply because most of our oil imports are used for transportation. Therefore, it is worth noting that several of our allies and adversaries have adopted a more expansionary natural gas policy because of their belief that it can in fact be used as a motor fuel.

- *New Zealand* has made the most extensive commitment in this regard. At the time of the first oil shock in 1973, the government purchased a 50% interest in the 5.5 trillion cubic foot Maui gas field and entered into a 20 year take-or-pay contract for the remainder of the production which would commence in 1979. The second oil shock convinced the government that it should utilize this natural gas to reduce New Zealand's oil imports, thereby assuring greater supply security *and* reducing foreign exchange obligations at a time when export earnings were declining. Therefore, in 1979 the Liquid Fuels Trust Board, entered into an agreement with Mobil to construct a synthetic fuels plant which would convert about 140 million cubic feet of gas per day into some 12,000 BPD of gasoline. The plant employs a Mobil process which converts gas to methanol and methanol to gasoline in a single integrated complex. When completed in 1985, the plant is estimated to cost about $1.5 (U.S. dollars of the day) and will be owned 75/25 by the New Zealand government and Mobil. While this represents an enormous investment for the government, it will make New Zealand 40-50% self-sufficient in transportation fuels by 1987. It was said to be a break-even venture in cash flow terms if the real price of world crude oil averaged no more than $28 per barrel in mid-1980 New Zealand dollars.

- *East Germany* and the *Soviet Union* have also entered recently into an agreement which will use compressed natural gas as a motor fuel. (For additional details, see the *Oil and Gas Journal*, January 17, 1983, p.69).

The Availability of Pipeline Gas Imports

It is sometimes argued that we need not optimize U.S. natural gas production because we can rely upon future access to Canadian and Mexican gas whose supply security and reasonable price is purportedly assured by their being "locked into the U.S. market." While it is certainly true that both of our neighbors have huge gas reserves, it is highly unlikely that we will have the upper hand in negotiating for them. If, as some experts forecast, reduced U.S. exploration activity leads to a demand for 4 or 5 TCF of Canadian and Mexican gas in the latter part of the 1980s, we are likely to find ourselves with an increased reliance which is very costly in both political and economic terms.

o Canada exported over 700 billion cubic feet of gasto the U.S. last year (.7 TCF) at a cost to U.S. consumers of over $3.5 billion. Because that so-called "border price" of $4.94/mcf was well above the price of competing U.S. gas, actual Canadian exports were only half the volume authorized by the Canadian government and only one-third of the almost 2 TCF/year which will be available theoretically by the late 1980s. There is little doubt that Canada will have an export potential for years to come, but it is likely that it will be high priced because perhaps 60% of Canada's proven and potential gas resources lie in the "frontier" regions of the offshore Atlantic and Canadian Arctic which, like our own Alaskan gas, is extremely costly to produce and transport. Although Alberta and British Columbia have some 70 TCF of proven "conventional" reserves, the Canadian government seeks to utilize this lower cost "conventional" gas at home. In fact, the government is offeringtransportation and fuel substitution subsidies in an effort to expand current Canadian consumption of 2 TCF/year by 50%. In addition to efforts to expand domestic utlization, Canada is seeking to diversify its gas markets by recently authorizing the first export of LNG to Japan (2.5 TCF). As a result of this governmental intervention in the Canadian gas industry, it appears certain that future Canadian exports to the U.S. will continue to be at prices higher than the market-clearing price of domestic U.S. gas.

o Mexico's current gas exports to the U.S. are limited by pipeline capacity to about 100 billion cubic feet per year (.1 TCF). That gas is priced at parity with Canadian gas at $4.94/mcf at the border. Although Mexico has some 75 TCF in proven gas reserves and several hundred TCF in potential resources, it is unclear that this will ever provide a secure or reasonably priced supply to the U.S. Like Canada, the Mexican government is seeking to expand domestic consumption which is currently 1 TCF/year. This reflects a desire to maximize the volume of Mexican oil which is available for export because, for a variety of reasons, oil exports make a far greater contribution to the Mexican economy on an equivalent BTU basis:

- -- Investments in oil export potential are less capital intensive and more quickly recovered than gas, a consideration which is especially important in view of Mexico's current financial crisis but which is also a factor in a capital short economy even in the best of times
- -- Oil netbacks are higher because pipeline transportation costs for gas are twice those for oil on a thermal equivalent basis (they are 5 to 7 times as much for LNG carriers)
- -- Oil offers greater potential for market diversification
- -- Oil is less highly specialized and somewhat more labor intensive in a country which needs jobs

Foreign Gas Pricing Policy

Some critics of proposals to deregulate all U.S. gas argue that market-clearing prices would be above the level of foreign gas prices, thereby reducing the ability of U.S. petrochemicals to compete on world markets and foreclosing opportunities to import foreign LNG at purportedly lower prices. Their arguments are based upon the belief that the vast world-wide natural gas reserves will be developed and that the governments which own them will have to engage in cut-throat competition for export markets. Before we accept this assumption as justification for risking probable future supply shortages under continued application of the Natural Gas Policy Act, we would do well to examine the pricing policies applicable to gas which is now moving in world trade.

- o The Soviet Union's new gas contract with West Germany is, like many international gas contracts, tied to an index of oil prices. Although international oil prices are currently falling, German gas buyers will not enjoy this advantage because the Soviet contract also contains a floor price which is expected to reach about $5.70/mcf by the end of the decade (the approximate equivalent of $34 oil). Nor can the Germans reduce their purchases, for the contract also contains a take-or-pay provision for 80% of the contracted volume.

- *Algeria*, the only OPEC member which exports pipeline gas (to Italy) as well as LNG (to the United States and Western Europe), has forced buyers to renegotiate their contracts so that prices approach parity with oil prices on a net-back basis. This makes LNG extremely costly because of the enormous liquefaction and transportation investments which are not involved in international oil trade. Since buyers -- and the Federal Energy Regulatory Commission -- are loathe to accept these prices, most analysts are pessimistic about future prospects for LNG trade. Algeria, and other producers with large gas reserves, have several options which are presently more attractive than gas exports:

  - Internal consumption accounted for 35% (8.7 billion cubic feet per day) of OPEC gas production in 1981, largely in industrial use (power generation, refining, petrochemical feedstock and fuel)

-- Reinjection accounted for 25% (6.5 billion cfd) of OPEC gas production in 1981. This technique is useful both to store gas for future recovery and to maintain pressures in order to increase ultimate oil recovery and production rates especially from sandstone reserviors. For example, prior to the overthrow of the Shah, Iran planned to reinject 12.3 billion cubic feet per day in order to stabilize oil production at 5-6 million BPD for several years.

SUMMARY

In closing, we can summarize a number of conclusions from the strategic and international context in which our allies and adversaries make natural gas decisions:

1. Unlike the United States, other countries encourage the use of natural gas as boiler fuel by utilities and industries. In fact, they are willing to pay substantially higher prices than U.S. consumers pay because they recognize the environmental and strategic diversification benefits of burning gas.
2. Notwithstanding the conventional American wisdom that gas can only be substituted for stationery uses, several countries are making huge investments to transform natural gas into motor fuel. They justify these investments on the basis of greater supply security and price stability in the transportation sector.

3. American confidence in the availability of reasonably priced pipeline imports from Canada and Mexico is likely to prove misplaced. Those countries have strong incentives to utilize their least expensive domestic gas at home, thereby decreasing oil imports in the case of Canada and increasing oil exports in the case of Mexico.

4. The cost of U.S. gas at market clearing levels is likely to be well below the delivered cost of gas imports to the rest of the world. In fact, the economics of international gas trade are likely to limit future gas exports unless importers are willing to pay a substantial premium.

In short, all of the strategic and international considerations point to the desirability of removing federal controls which currently impede the production and utilization of U.S. natural gas. Therefore, I would urge Congress to deregulate natural gas in the most politically expeditious manner.

Senator NICKLES. Gentlemen, I very much appreciate your comments. I have some questions that I will submit to you. I am just running out of time and I apologize for that and I apologize for the fact that you ended up basically I think on the tail end of the switch in the middle of lunch, and the fact that we had a 15-minute break and so on, because I think many of your comments are very well made and I will have some questions.

I would like to have your response to those in the record to kind of, I think, show a little commonsense in response to some limits that we face on natural gas, and I am impressed by both of your statements that you made and the manner that you made them and the brevity that you made them. I think they are very well put and really right on target, and so thank you for that, and again I apologize for the fact that we kind of ended up working through the lunch hour, so thank you very much.

The committee is adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned, subject to the call of the Chair.]

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